No. 21,232

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

UNITED STATES OF AMERICA,

Appellant and Cross-Appellee,

v.

HANNA NICKEL SMELTING COMPANY, a corporation, and
THE HANNA MINING COMPANY, a corporation,

Appellees and Cross-Appellants.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE DISTRICT OF OREGON

BRIEF FOR THE UNITED STATES AS APPELLANT

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JURISDICTIONAL STATEMENT

This action to recover alleged erroneous overpayments made to Hanna Nickel Smelting Company under a public contract, and to obtain reformation of the price paid under a portion of the contract, was brought by the United States under 28 U.S.C. 1345. The total recovery sought was $1,641,974.57 plus interest from the dates of the overpayments. The district court (Chief Judge Gus J. Solomon presiding) tried the case without a jury, and on February 24, 1966,

entered its opinion (R. 375).[1/] On April 27, 1966, a supplemental opinion, and the final judgment awarding the United States $473,304.32 plus prejudgment interest of $87,328.57 were entered (R. 465, 468). Appeals from that judgment were noted, by the United States on June 23, 1966, and by the defendants on the following day (R. 470, 472). On July 27, 1966, the district court extended the time for docketing the appeals to August 22, 1966, and the appeals were docketed in this Court on that date (R. 493). The Court has jurisdiction of these appeals under 28 U.S.C. 1291.

STATEMENT OF FACTS

During the Korean War, the Government became concerned about the lack of facilities in the United States for the production of nickel, an essential defense metal (R. 215). In February 1951, the then Chairman of the Preparedness Subcommittee of the Senate Armed Services Committee (Senator Lyndon B. Johnson) invited the then president of the M. A. Hanna Company (George M. Humphrey) to report to the Subcommittee its plans for developing the nickel deposits in Oregon on which the company had obtained options, including the need, if any, for Government aid (R. 215). In 1952, The Hanna Mining Company (M. A. Hanna Company then owned 59% of its voting stock) commenced negotiations with the Defense Materia

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1/ The reference "R." is to the transcript of record; three xeroxed copies of the record have been provided for the use of the Court.

Procurement Agency for a contract for the development of a nickel mine and smelter (R. 214-215).

On January 16, 1953, The Hanna Mining Company (hereafter "Hanna Mining") contracted with the Government to open and operate a mine on property it had leased in Oregon and to sell nickel-bearing ore (a minimum of 95 million pounds and a maximum of 125 million pounds) from that mine to the United States on specified terms (R. 215-216). During the term of that contract, from January 1953, through March 1961, the Nickel Division of Hanna Mining -- according to its tax returns, books and records -- realized a net profit after taxes of $10,469,814 on the sale of ore to the United States (R. 218). During the same period, the total cost of operating the Nickel Division was $12,022,898 without taking taxes into account (R. 218). These figures indicate that Hanna Mining realized a profit of more than eighty-seven percent (87%) of incurred costs on its contract with the Government.[3/]

Also on January 16, 1953, the Government entered into a contract with a wholly-owned subsidiary of Hanna Mining, Hanna Nickel Smelting Company (hereafter "Hanna Smelting"), incorporated on January 15, 1953 (R. 214).[4/] Under that contract,

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2/ The Defense Materials Procurement Agency was then an independent agency of the United States; in August 1953, the agency was abolished and its functions transferred to the General Services Administration (R. 214).

3/ According to the appellees, the net profit was some $2.9 million less than the $10.4 million figure because of adjustments they believed appropriate "for expenses of development, research, administration, exploration and similar items" (R. 218).

4/ Two contracts in addition to the mining and smelting contracts were entered into on January 16, 1953. In one (continued)

the Government agreed to finance with public funds Hanna Smelting's activities in developing a commercially feasible process for smelting ore from the Nickel Mountain, Oregon, mine; in building smelting facilities adjoining the mine in which to apply the process; and in operating the smelter to produce, during the period of the contract, an agreed quantity of refined nickel for sale to the United States. In addition, the Government agreed to sell to Hanna Smelting -- without profit -- all the ore it purchased from Hanna Mining (R. 216). In practice, Hanna Mining delivered the ore directly to Hanna Smelting; the latter then paid its parent company for the ore and obtained reimbursement from the Government (R. 216).

The dispute in this litigation involves the meaning and construction of various provisions of the contract between Hanna Smelting and the Government.

1. The Contract Between Hanna Nickel Smelting Company and the United States.

Under the contract between Hanna Smelting and the United States, Hanna was immediately to erect the facilities necessary

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4/ (continued) of them, Hanna Mining agreed to provide Hanna Smelting with management supervision for a cash consideration of $100,000 per year after September 30, 1955 (R. 216). Hanna Smelting, in turn, was entitled to treat those amounts as "costs of production" under its contract with the Government and obtain reimbursement from the United States for them (R. 207). In the other contract, Hanna Mining guaranteed reimbursement to the United States in the event Hanna Smelting spent the funds advanced by the Government in violation of the smelting contract (R. 216).

for testing the process of smelting ore from the Oregon mine (Pl. Exh. 1, p. 1), [5] and if the process proved feasible, to complete the facilities needed for the production of a minimum of 95 million pounds and a maximum of 125 million pounds of saleable ferro-nickel for sale to the Government under the contract (ibid.). [6] In this connection, Hanna Smelting agreed to undertake in France tests on the production of nickel from Nickel Mountain ore by the "Ugine Process" (Pl. Exh. 1, p. 2). Thereafter, Hanna Smelting was to report the results to the Government and obtain reimbursement for the costs incurred (ibid.). [7]

The heart of the contract is contained in Article IV (dealing with the smelting facilities to be built), in Article VI (governing advances of capital and operating money to Hanna from the United States), and in Article VIII (establishing the price to be paid by the United States for the smelted nickel). More specifically, Article IV, "Facilities", provides (Pl. Exh. 2, p. 2):

5/ "Pl. Exh." refers to the Government's exhibits in the district court; "Dft. Exh." will be used in referring to the exhibits introduced by the appellees. Three copies of most of the more significant exhibits have been xeroxed for the use of the Court and may be found in the tabbed Book of Exhibits.

6/ Saleable ferro-nickel was defined as ferro-nickel in sound ingots of 20 to 60 pounds size with a minimum of 25 percent nickel content and containing less than specified amounts of specified impurities (Pl. Exh. 1, p. 2).

7/ An amendment to the contract authorized additional tests to be made in France (Pl. Exh. 2, p. 2).

> With Advances made by the Government as provided in Article VI, the contractor will construct and equip (including any necessary redesigning, rebuilding and repair) * * * a facility for the conversion of ore from the Mine into saleable ferro-nickel. * * * [T]he facility shall consist of * * * [specifically described items of equipment] 8/ and all equipment and facilities agreed to by the Government as necessary for such conversion of ore from the Mine into saleable ferro-nickel. * * * The facility, as it exists from time to time as contemplated by this Article or as it may be substituted for from time to time with the approval of the Government, is hereinafter called 'the Facility'.

Hanna Smelting's activities were to be financed almost entirely with public funds. The contract provision regulating financing (Article VI, "Advances") provided for two types of cash advances to be made by the Government: "capital advances" and "working capital advances" (Pl. Exh. 1, pp. 4-5). With respect to capital advances, Article VI, paragraph 1, provided (ibid.):

> Upon the Contractor's written request, the Government will make advances (hereinafter called "Capital Advances") of the entire amount up to a total of $22,875,000 9/ * * * required (a) to test the process as provided in Article II, * * * , (b) to construct, equip, design and rebuild the Facility contemplated by Article IV * * * , (c) for such replacements or improvements of the Facility

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8/ Following is a list of the equipment specifically described in Article IV: "one electric refining furnace, two electric melting furnaces, one electric ferro-silicon furnace, one electric slag melting furnace, a slag-disposal site and equipment, a stockpile site and stockpiling equipment, a sewage-disposal plant, railroad spurs, housing for personnel, preliminary construction and foundations for two additional electric melting furnaces and facilities as may be required after Period 1" (Pl. Exh. 2, p. 2).

9/ That amount was increased from $22,000,000 by Amendment No. 4 dated November 8, 1957 (R. 206; Pl. Exh. 16).

which are agreed by the Contractor and the Government to be necessary or advisable during the period of this Contract, and (d) for such other necessary and so agreed upon expenditures which, in accordance with generally accepted accounting practice, are capitalized.

With respect to working capital advances, Article VI, paragraph 2, provided (Pl. Exh. 1, pp. 4-5):

> Upon the Contractor's written request from time to time * * * , the Government will advance to the Contractor sums (hereinafter called "Working Capital Advances") representing its reasonable minimum working capital requirements so long as the sum of such request plus Working Capital Advances then outstanding does not exceed $3,750,000. 10/ * * * Working Capital Advances may be requested and used by the Contractor to pay any costs and expenses hereunder of the Contractor, including costs arising from the payment of tax liability or other source, not covered by Capital Advances * * * .

Article VI further required that "Capital Advances and Working Capital Advances shall be kept in separate accounts at a bank or banks approved by the Government, shall not be commingled with each other or with other funds" and shall "bear interest at 5% computed on a daily basis" (id. at p. 5). All advances were to be evidenced by notes and secured by mortgages on "the Facility" (id. at pp. 5; 16-17). 11/

10/ That amount was increased from $2,800,000 by Amendment No. 4 (Pl. Exh. 16; R. 206).

11/ From January 1953 to April 1961, the Government made total capital advances of $22,300,000 and working capital advances of $69,945,000 (R. 298). Although an additional $575,000 of capital advances was authorized by the contract, Hanna Smelting never requested that that amount be advanced and, in fact, it refunded $27,444 of unused capital advances during that period (R. 298).

The contract did not per se provide for a profit to be made by Hanna Smelting on the sale of refined nickel to the United States. Rather, Article VIII -- "Sale and Purchase of Ferro-nickel" -- provided that the price per pound to be paid by the United States would be determined by adding (R. 207): 12/

> (a) the Contractor's actual cost of production per pound of contained nickel (but not more than * * * [the agreed ceiling]) and (b), but only in the case of the first 95,000,000 pounds of contained nickel in ferro-nickel * * * sold to the Government, an amount per pound of contained nickel (hereinafter called "Amortization Payment") sufficient to amortize the Capital Advances made pursuant to Article VI plus interest thereon.

Article VIII then set forth the meaning of "actual cost of production" for which the contractor would be reimbursed (R. 207-208):

> The Contractor's actual cost of production * * * [shall be subject to the agreed ceiling and] shall mean and include (a) until the end of the three year period from the calendar quarter commencing closest to the beginning of Period 3, 13/ all theretofore unrecovered costs and expenses hereunder of the Contractor * * * not covered by Capital Advances and which arise from operations, payment of royalties, management and consultants' fees, insurance, interest on Working Capital Advances, state and local taxes, or other sources, excluding federal income taxes and (b) thereafter, for each running period of three consecutive years, only such costs and expenses * * * as are incurred during or with respect to such three year period.

12/ Article VIII, as originally executed, was modified by Amendments 3 and 4. The language set out above reflects the clause as amended.

13/ Period 3 commenced on September 30, 1957 (R. 208).

The Government was to pay for each lot of saleable ferronickel delivered promptly after receipt of Hanna Smelting's invoice covering the lot (Pl. Exh. 1, p. 10). The amortization payments (i.e., the "capital advance repayments") were to be deducted from the amounts of the invoices and credited first against interest on capital advances and then against outstanding capital advances (ibid.).

The contract also specified various optional methods for its being terminated (Pl. Exh. 1, pp. 12-15). The option actually exercised, contained in Article XIV, provided that (id. at p. 13):

> [T]he Contractor will pay to the Government the amount of the then unpaid Capital Advances together with accrued interest thereon plus the amount of any unpaid Working Capital Advances together with accrued interest thereon, and plus an amount (hereinafter referred to as the "Residual Payment") equal to 7-1/2% of total Capital Advances excluding advances for capital replacements.

Upon Hanna Smelting's repayment of all outstanding advances and payment of the residual payment under the option, the Government was to transfer to it clear title to the entire facility. 14/

14/ In March or April 1961, Hanna Smelting exercised the option to purchase the smelter and made a negotiated residual payment of $1,721,653 to the Government; in return, it received clear title to the smelter (R. 217, 298). The extent to which Hanna profited from exercising the option is documented in the record. In May 1960, Hanna had insured the facility for $16,514,000, and in January 1962, the American Appraisal Company set its fair market value as of January 1, 1961, at $10,670,000; the Oregon State Tax Commission and Hanna Smelting agreed for State tax purposes that the smelter had a value of $15,113,240 in 1961 (R. 218). Thus, for the sum of $1.7 million, Hanna Smelting obtained from the United States a smelter worth at the very least $10.7 million, and more likely worth in excess of $15 million.

The contract thus did not provide for a profit as such to be made by Hanna Smelting on the sale of nickel to the United States. Rather, it provided that the Government would lend Hanna up to $22,875,000 of public funds to construct the Facility and would advance the funds needed to operate the Facility to produce the agreed quantity of smelted nickel for sale to the United States. And the contract further provided for the Government, when purchasing the smelted nickel, to reimburse Hanna for its actual costs of production (up to the agreed ceiling price per pound), including a management fee of $100,000 a year to be paid by Hanna Smelting to its parent corporation, Hanna Mining. See fn. 4, supra, pp. 3-4. Thus, Hanna Mining received a profit of $10,469,814 (of 87% of costs) on the nickel mining contract, and a "management fee" of at least $500,000 ($100,000 per year for at least the five years September 1955 through September 1960) on the smelting contract. In addition, Hanna Smelting was expected to, and did, obtain a very substantial profit when, by paying the difference between the cost of the facility and approximately 7 1/2% of that amount, it obtained clear title to the facility. Thus, in addition to the $10,469,814 profit and management fees of at least $500,000 made by Hanna Mining as a result of the contractual arrangements, its wholly owned subsidiary, Hanna Smelting, obtained for the sum of $1.7 million a smelting facility worth more than $15 million, for a profit of more than $13.3 million. See fn. 14, supra, p. 9. And, ever since its acquisition of the smelter, Hanna

has been using the facility for the profitable commercial production of smelted nickel.

This litigation does not concern the fact that the Hanna Companies effectively realized a profit of more than $24,000,000 under the contractual arrangements, with an expenditure of only about $12 million. Rather, it concerns the question of whether, in addition to the profits contemplated by the contract as set forth above, Hanna had a right to charge to the Government substantial expenditures (approximately $1.4 million) for replacements and improvements and additions to the facility, over and above the more than $22 million contemplated for capital expenditures, and without approval by the Government, when most of those items of equipment were long lived and could be expected to be (and were) used by Hanna for commercial production of nickel after the termination of contract here.[14a/]

2. The Nature of the Litigation.

a. The Government's Main Claim.

This suit essentially involves the propriety of Hanna Nickel Smelting Company's treatment as costs of production (rather than as capital expenditures) of $1,392,376.55 spent for 216 items that appellees conceded were literally additions, replacements,

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14a/ The uncontradicted evidence is that at the time of trial, Hanna Smelting was still using disputed items which had cost a total of $715,899 -- or more than one-half of the total -- in the highly profitable commercial production of nickel. See Pl. Ex. 72 and fn. 37a, p. 52, supra.

or improvements to the smelting facility.[15] In terms, the contract contemplated that additions, modifications and "replacements or improvements of the Facility" would be treated as capital items. Article VI, para. 1, clause (b) quoted, supra, pp. 6-7 . As mentioned above (supra, p. 6), however, the contract set a dollar limit ($22,875,000) on capital expenditures that would be shouldered by the Government, and required that Hanna obtain the approval of the Government as to the necessity for, or advisability of, making such expenditures. By December 31, 1957, Hanna had spent $22,300,000 on capital items, virtually exhausting the capital funds available (Pl. Exh. 7). By contrast, the contract gave Hanna Smelting sole discretion to determine the necessity for or advisability of, expenditures for costs of production, and placed a dollar limit on costs; during the life of the contract, Hanna was, with a minor exception, able to stay within that dollar limit. Since Hanna had not sought or obtained the approval of the United States as to the spending of the almost $1.4 million involved here, and since (in the Government's view) the expenditures for additions, replacements, or improvements to the facility were for capital items and not for costs of production, the Government claimed that Hanna had overcharged it for nickel by that amount (Complaint, First Count, R. 1-4). Stated otherwise, Hanna

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15/ In the Defendants' Brief After Second Trial filed in the district court, the appellees conceded (ibid. p. 6) that "most if not all of the disputed items were in a sense literally additions or replacements or improvements * * * ."

The complaint as initially filed by the Government sought recovery of over $1.7 million expended for 284 items of equipment (R. 3). During the course of the litigation, the amount sought was reduced to the present figure of approximately $1.4 million.

Smelting stood to obtain three distinct advantages from treating expenditures for the disputed items as costs of production rather than as capital expenditures. First, it did not need to obtain governmental approval of expenditures for costs of production, whereas such approval was required for the spending of capital advances. Second, since Hanna was able over almost the entire life of the contract to produce nickel at less than the agreed price per pound limitation, it could easily pass the cost of all the disputed items on to the Government as reimbursable costs of production; on the other hand, since a firm dollar limitation had been set on capital advances, it could not have done so had it followed the capital advance route. And third, by not treating the expenditures as capital expenditures, it reduced the price it was required to pay to obtain title to the Facility upon contract termination (i.e., it paid 7 1/2% of a reduced figure).

More specifically, the basis of the Government's claim may be summarized as follows: The price the Government was to pay for nickel under Article VIII of the contract (supra, p. 8), was to be that amount (subject to a ceiling price) which would reimburse Hanna Smelting for its "actual cost of production per pound of contained nickel." 16/ That article defined "actual cost of production" as the "costs and expenses hereunder of the Contractor * * * not covered by Capital Advances and which arise from operations * * * " (emphasis supplied).

16/ That amount was to be reduced by the "amortization payment" -- the figure calculated to credit the Government on a poundage basis with the funds advanced to Hanna to make capital expenditures (see p. 8 , supra).

Under Article VI, paragraph 1 (supra, pp. 6-7) capital advances of up to the total amount of $22,875,000 were available --

> "(a) to test the process * * * ,"
>
> "(b) to construct, equip, design and rebuild the Facility contemplated by Article IV,"
>
> "(c) for such replacements or improvements of the Facility which are agreed by the Government to be necessary or advisable during the period of this Contract, and"
>
> "(d) for such other necessary and so agreed upon expenditures which, in accordance with generally accepted accounting practice, are capitalized."

And, Article IV (supra, p. 6) defined "the Facility" as follows:

> [T]he facility shall consist of * * * [specifically described equipment] and all equipment and facilities agreed to by the Government as necessary for such conversion of ore from the mine into saleable ferro-nickel. * * *

Reading Articles IV and VI together -- i.e., replacing "the Facility" in clauses (b) and (c) of Article VI with the definition of that term in Article IV -- capital advances were available (for among other things):

> (b) to construct, equip, design, and rebuild the specifically described equipment and all equipment and facilities agreed to by the Government as necessary for such conversion of ore, and
>
> (c) for such replacements or improvements of the specifically described equipment and all equipment and facilities agreed to by the Government as necessary for such conversion of ore, which

are agreed by the Government to be necessary or advisable during the period of this Contract.

The disputed expenditures, the Government urged, fit into those categories for which capital advances were available under Article VI; they were not, therefore, properly treated as costs of production.

For example, among the original equipment purchased by Hanna for the smelter were "two dutch oven type dryer furnaces." 17/ The purpose of the ovens was to heat two dryers designed to remove the moisture contained in the nickel ore. The two original dutch ovens were purchased by Hanna Smelting with capital advances of $89,110 -- they were not purchased with working capital advances and were not treated as "costs of production". By 1957, Hanna determined that the ovens did not have sufficient capacity to supply the necessary heat and that, to dry the ore properly, replacement units were necessary. Hanna decided to purchase two new dutch ovens having almost twice the heating capacity of the old ones and better draft characteristics, and costing $97,372.90. The new ovens had an estimated useful life of twenty years (Pl. Exh. 166).

In the Government's view, the new dutch ovens were "replacements or improvements" of equipment originally agreed to by the Government as necessary for the conversion of ore, within the meaning of clause (c), paragraph 1, of Article VI. Accordingly,

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17/ The description of the dutch ovens that follows is taken from Pl. Exh. 82, Item 43. That exhibit contains the parties' stipulated, agreed descriptions of all the disputed items.

capital advances should have been employed for the purchase of the dutch ovens, provided the Government agreed that the expenditures were "necessary or advisable" and provided the ceiling on capital expenditures (then $22,000,000) had not been exceeded. Hanna Smelting did not, however, ask the Government to make capital advances to cover the expenditure of $97,372.90 for the ovens. Instead of seeking Government approval of the expenditure -- as would have been necessary were capital advances requested -- Hanna used working capital advances to purchase the ovens -- even though it had convenanted to use working capital advances only "to pay any costs and expenses * * * not covered by Capital Advances" (Article VI, paragraph 2). Hann then treated the purchase price of the ovens on its books and records as "actual costs of production" for which it thereafter obtained reimbursement since the price the Government paid for nickel under Article VIII was designed to reimburse Hanna's "actual cost of production per pound of contained nickel."

Each of the 216 disputed expenditures, the Government urged, was similar to the expenditure for the dutch ovens. Since each was an expenditure for additions, replacements, or improvements to the smelting facility, Hanna Smelting breached its contract in two ways: first, it used working capital advances to acquire capital items, thereby circumventing the requirement that it obtain the agreement of the Government that additional capital expenditures were "necessary or advisable"; second, it caused the Government to overpay for nickel by almost $1.4 million by treati

the expenditures for the 216 disputed items as reimbursable costs of production when in fact they were not costs of production under the contract terms.

The appellees' main line of defense to the Government's claim was that the accounting treatment of the 216 disputed items was to be determined solely by reference to accounting practice in the smelting industry. Its theory was that the words "which, in accordance with generally accepted accounting practice, are capitalized" that appear in clause (d) of Article VI, paragraph 1 (supra, p. 7) must be read into clauses (b) and (c). And, going one step further, Hanna urged that the phrase "generally accepted accounting practice" used in the contract actually meant "generally accepted accounting practice in the smelting industry." Thus, in Hanna's view, clause (c), paragraph 1, Article VI must be read -- not as written (see p. 7 , supra) but rather -- as providing that capital advances were to be used "for such replacements or improvements as are required to be capitalized in accordance with generally accepted accounting practice in the smelting industry." 18/ On this theory, Hanna claimed that all 216 expenditures were properly expensed rather than capitalized.

In response to this argument, the Government argued in the alternative that even if -- contrary to the plain language of the contract -- the phrase "generally accepted accounting practice" appearing in clause (d) were to be read into clauses (b)

18/ See pp. 7-8 of Defendants' Brief After Second Trial.

and (c), there was absolutely no indication (in the contract or otherwise) that the parties intended that phrase to mean accounting practices peculiar to the smelting industry. And, the Government pointed out, if generally accepted accounting practice governed, then 201 of the 216 disputed items, costing a total of $1,372,845.57, were improperly charged by Hanna Smelting to cost of production. 19/

Hanna's second line of defense to the Government's claim consisted of various "equitable claims and defenses." In its answer to the Government's complaint, Hanna contended that the Government's claim was barred by laches and that, if the disputed items had been complained about during the course of the contract, the United States would "in any event" have borne their cost (R. 143-144). Another defense asserted was that Hanna Smelting's accounting treatment of the disputed items was fully known to the Government's "authorized representatives" during the course of performance of the contract and that, in reliance on the Government's failure to object, Hanna "changed its position to its detriment" (R. 144-145). The change in position alleged was that, had Hanna timely known of the Government's objection to its treating allegedly capital items as reimbursable costs of production, it could have refrained from making the expenditures unless the Government furnished capital advances to

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19/ Pl. Exh. 172 demonstrates that if generally accepted accounting practices obtain, then only 15 of the disputed items, costing a total of $19,530.98, would not be recoverable. Of that amount, the exhibit further shows, $11,226.39 would not be recoverable only because the record lacked sufficient evidence on which to conclude that it was improperly expensed.

cover the expenditures (R. 145). Based on these allegations, Hanna asserted that the United States "is and should be estopped in equity and good conscience from attempting to assert its present position and it has waived the right to do so" (ibid.). Finally, the answer alleged, even if Hanna Smelting "did not literally comply in all respects with the express terms of" the contract, the Government sustained no damage because the challenged expenditures reduced the cost of producing nickel "by not less than $865,119" (ibid.).

b. The Government's Subsidiary Claims.

The complaint filed by the United States in this action stated three counts in addition to the first count (R. 1-4), which sought recovery of almost $1.4 million of alleged overpayments, as summarized above. The second count of the complaint sought recovery of other amounts erroneously paid Hanna Smelting as reimbursement for three particular items charged to costs of production (R. 4-5). That count was dismissed by stipulation on February 12, 1964, after Hanna Smelting paid the Government $63,525.47, representing the full amount of the claim plus 6% interest (R. 118-119).

The third count alleged that by amendment to the contract, the parties agreed that deliveries of smelted nickel after March 31, 1961 -- 105,500,137 pounds had been delivered as of that date -- would be paid for at a price per pound (not in excess of 58.77 cents) that would repay Hanna Smelting its average

actual cost of production per pound of contained nickel (R. 5).[20] The computation of the ceiling price of 58.77 cents per pound had been based on an agreed formula incorporating the figures reported by Hanna Smelting as its costs of production for 1959 and 1960 (R. 5). However, since many of the disputed expenditures challenged in count one had been charged to costs of production in 1959 and 1960, the ceiling price did not reflect the intent of the parties to establish a ceiling based on Hanna's actual costs of production during 1959 and 1960 (R. 6). Accordingly, reformation downward of the ceiling price and recovery of the resulting overpayment were sought (R. 6).[21] Hanna's defense to the count for reformation was that revision downward of the 58.77 cents per pound ceiling price would be "inequitable" (R. 137-143).

The final count of the complaint alleged that Hanna Mining Company was joined as a party on its agreement to reimburse the United States in the event its subsidiary, Hanna Smelting, expended public funds in violation of the smelting contract (R. 6). Hanna Mining admitted that it had guaranteed proper performance by Hanna Smelting (R. 143).

20/ From March 31, 1961, until the time the complaint was filed, 2,186,409 pounds of nickel had been delivered and paid for at the rate of 58.77 cents per pound; at the time the complaint was filed, Hanna Smelting was still obligated to deliver an additional 17,313,454 pounds of nickel (R. 5).

21/ After the complaint was filed, the parties entered into an agreement by which Hanna's obligation to deliver the additional 17,313,454 pounds of nickel required by the contract was terminated in consideration of a cash payment to the Government (R. 132). This agreement was consummated apparently because it was more profitable for Hanna to sell the smelted nickel commercially rather than to the Government under the contract. That agreement also provided that if the 58.77 cents ceiling price were revised downward in this litigation, Hanna would pay the United States an amount equal to 17,313,454 times the difference between 58.77 cents and the revised ceiling (R. 135).

3. The Proceedings in the District Court.

After the pleadings were filed, the district court granted, over the Government's objections, Hanna's motion under Rule 42(b), F.R. Civ. P., for a separate trial on the "equitable issues and defenses" raised by their answer (R. 147). In October 1964, following the entry of an extensive pretrial order (R. 201-251), those issues were tried to the district court.[22/] Then, in May 1965, the district judge wrote the parties that he had decided to hear all the evidence and render a decision on the entire case, rather than decide it "piecemeal" (R. 286). Thereafter, an extensive supplemental pretrial order (R. 295-331) was entered, and in July 1965 the main issues were tried to the district court.[23/] As a result of the extensive pretrial proceedings, many of the facts were stipulated and a great deal of the evidence is documentary.[24/] As a result, the live evidence taken on the main issues consists largely of the opinion testimony of various accountants.

22/ The reporter's transcript of that trial comprises Volumes 3 and 4 of the Transcript of Record in this Court. The evidence on the issues at the first trial is summarized and discussed in the portion of the argument dealing with those issues, infra, pp. 86-93. "Oct. Tr. ___" will be used in referring to that transcript of the October 1964 trial.

23/ The reporter's transcript of the July trial is in four volumes and comprises Volumes 5 through 8 of the Transcript of Record in this Court. The reference "Jul. Tr. ___" will be used in referring to that transcript.

24/ In excess of 300 exhibits were introduced at the trials (see R. 324, 328).

Among the evidence introduced at the trials were various drafts of the smelting contract prepared by the parties during contract negotiations. Other exhibits reflect on each party's construction of the terms of the contract during the course of performance. These exhibits will be summarized and discussed in the argument portion of this brief. A central exhibit previously mentioned (supra, p. 14), contains the agreed descriptions of the 216 disputed items charged by Hanna Smelting to costs of production (Pl. Exh. 82). One of those items -- Item 43, the expenditure of $97,372.90 for "two dutch oven type dryer furnances" -- was previously mentioned. Another example of the nature of the disputed items, concerns the expenditure of $198,746.62 for "dust collecting equipment," Item 49.[25/] The smelter, as originally constructed, contained dust collecting equipment designed to remove nickel particles escaping from the facility in the form of dust. The $216,000 cost of the original dust collecting equipment was paid with capital advances (and accordingly was not treated as costs of production). The dust problem, however, was more acute than Hanna had originally anticipated and Hanna decided to install a more efficient type of dust collecting equipment. In 1957, $893,364 was expended for the new equipment, for removing the

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25/ The facts relating to this item in Pl. Exh. 82 were augmented by stipulation entered in November 1965, following the trial (R. 336-337), and by Pl. Exh. 89.

old equipment, and for removing and replacing the necessary ducts. Of that total amount, "$694,618 which pertained to the new equipment were charged to a capital account," i.e., capital advances were used to cover the expenditure. However, $198,746.62 of the total amount was charged to costs of production. Of the latter figure, $114,234.82 was expended for "fabrication, equipment, erection and installation of new dust collection equipment," and $47,933.83 was spent "for removing old dust collection equipment" (R. 337). It is uncontradicted that, when installed, the dust collecting equipment had a useful life of 15 years (Pl. Exh. 166), and the equipment was being used by Hanna in connection with the commercial production of nickel at the time of the trial of this action (Pl. Exh. 72).

In addition to the documentary exhibits introduced into evidence, the Government presented the testimony of an expert accounting witness, Dr. Howard W. Wright, who is a professor of accounting and a certified public accountant and has had extensive Government contract experience (Pl. Exhs. 178, 179). Dr. Wright testified that if a contract sets out the basis for determining whether to capitalize or expense an expenditure, proper accounting procedure requires that the contract terms, and not general accounting principles and practices, be applied (Jul. Tr. 33, 37). Dr. Wright pointed out, however, that in the present case there were only minor differences between the

accounting procedures dictated by the contract terms and those required under generally accepted accounting principles (Jul. Tr. 38). He then testified that each of the 216 disputed expenditures were improperly treated under the terms of the contract as costs of production (Jul. Tr. 52-127). Dr. Wright further testified, in support of the Government's alternative position, that if generally accepted accounting practice were intended to control the allocation between expense and capital, 201 of the 216 disputed expenditures were improperly treated as costs of production (Jul. Tr. 77-119).

In support of their theory of the case, the appellees presented four accounting experts: Richard Baker, a partner in the accounting firm of Ernst & Ernst, Hanna's auditors (Jul. Tr. 155); Bruce F. Smith and Maurice Peloubet, partners in the accounting firm of Price, Waterhouse & Co. (Jul. Tr. 198, 215); and John W. Queenan, a partner in the accounting firm of Haskins & Sells (Jul. Tr. 229). As the district court noted in its opinion, the testimony of these accountants "was largely cumulative" (R. 384). They testified that they had reviewed the contract together as a team and had come to the conclusion that generally accepted accounting practice in the smelting industry was intended to govern the accounting treatment of the 216 disputed items (e.g., Jul. Tr. 158-164, 221). In their opinion, under accounting practices peculiar to the smelting industry, each of the 216 disputed items was correctly treated

as a cost of production rather than as a capital expenditure.[26] Hanna's witnesses did not testify as to the result that would obtain if generally accepted accounting practice -- and not merely generally accepted accounting practices employed in the smelting industry -- were found to be applicable. Thus, the testimony of Dr. Wright as to how the items would be treated under generally accepted accounting principles was not challenged by Hanna's expert witnesses.

4. The District Court Decision.

Following the second trial, the district court entered two opinions (R. 375, 465).[27] The court held that "the terms in Article VI, paragraph 1, are ambiguous, and that other provisions relied on by the Government do not resolve the ambiguity" (R. 383). The court then concluded that the words "replacement" and "improvement" as used in Article VI of the contract "are terms of accounting art," and that, "in determining how to account for a particular item, an accountant must look beyond the contract and rely on generally accepted accounting principles and practices" (R. 384). After summarizing the testimony of the

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26/ The testimony of these expert witnesses will be more fully discussed infra.

27/ In the second, or supplemental, opinion, the district judge stated that both opinions "shall constitute my findings of fact and conclusions of law" under Rule 52(a), F.R. Civ. P. (R. 467).

various accounting experts, the court then stated "in my opinion, the parties intended to apply accounting practices common to the smelting industry" in determining whether the disputed items should be treated as costs of production (R. 387). Thus, the court adopted Hanna's principal defense that, notwithstanding the language of Article VI, paragraph 1, classifying all replacements and improvements to the Facility as capital items, only those replacements or improvements which are treated as capital expenditures under accounting principles in the smelting industry were to be treated as capital items under the contract.

The court below rejected two theories advanced by Hanna (through its accounting experts) to justify charging two classes of items to costs of production. The first class consisted of 61 items, each costing under $1,000 (but costing in total $34,113.79) which had been expensed as de minimis. The court found that since Hanna "had not routinely followed this practice and had capitalized many items costing less than $1,000, * * * the Company cannot now rely on a practice which it did not consistently employ" (R. 388).[28/] The second class consisted of six items acquired by Hanna in 1960 and 1961 at a

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28/ Because Hanna's witnesses had testified that, in their opinion, the expensing of many of these items could be justified under one or more of the other practices permitted by the court, Hanna was given the opportunity "to reclassify any such items" (R. 388). In its supplemental opinion, the Court upheld the reclassification of 27 items costing a total of $15,915.52 into "approved categories" and the Government conceded that 2 other minor items costing $1,801.89 were properly costs of production (R. 466).

cost of $215,110. According to Hanna's witnesses, these items had been expensed on the theory that the savings to the Government on the price of nickel resulting from their installation promised to exceed their cost, and because Hanna would have been unable to recover their cost in the amortization element of the contract price had they been capitalized (R. 389). These items, the court below stressed, "the Company's witnesses frankly admit to be capital items under the accounting practices previously discussed" (R. 388). Accordingly, the court held that Hanna had improperly treated those two classes of expenditures as expenses, and that the United States was entitled to reimbursement for them.

Alternatively, the court held that: "[W]ith two exceptions, the Government is estopped by acquiescence from asserting any claim for expenditures made after January 1, 1958. This estoppel does not apply to the six items expensed in 1960 and 1961 solely to obtain reimbursement * * * [nor] to those miscellaneous items (under $1,000) whose expensing cannot otherwise be justified" (R. 390). The court found that the Government since 1957 knew of the accounting practices principally in dispute but failed to complain about them until July 1961 when it questioned $210,605 expensed in 1960 (R. 390, 394). With respect to the Government's argument that, even if estoppel were applicable in a case of this sort, one of the necessary elements of estoppel would be lacking because Hanna had not changed its position in reliance on the silence, the court held (R. 390-391):

> Where acquiescence is the ground for estoppel, there is no occasion for the party who claims the estoppel to change his position; he "relies" by continuing his established practice. Mahoning Investment Co. v. United States, 3 F. Supp. 622 (Ct. Cl. 1933), cert. denied, 291 U.S. 675 (1934).

On the Government's count for reformation of the contract, the court held that since Hanna Smelting had -- as previously found -- erroneously expensed a number of items during 1959 and 1960 (see pp. 25-26, supra), the 58.77 cents per pound ceiling price should be reformed to reflect the deletion of these items from costs of production (R. 395-396).

In its supplemental opinion, the district court accepted the reclassification by Hanna of a number of items (see footnote 28, supra, p. 25) and also awarded the Government 6% interest on the overpayments on the items found not properly charged as costs of production, finding this "a classic case of unjust enrichment" (R. 467).

The final judgment of the court, entered on April 27, 1966, awarded the United States the total amount of $560,632.89, broken down as follows (R. 468-469):

(a)	6 major items improperly charged to costs of production	$215,110.00
(b)	32 minor disputed items improperly charged to costs of production	16,396.00
(c)	6% prejudgment interest on (a) and (b)	79,603.87
(d)	reformation of price downward by $.0124 per pound for 17,313,454 pounds of nickel, in accordance with the parties' 1964 termination agreement	214,686.83
(e)	reformation of price for 2,186,409 pounds of nickel	27,111.49
(f)	6% prejudgment interest on (e)	7,724.70
	Total award	$560,632.89

SPECIFICATION OF ERRORS RELIED UPON

1. The district court erred in interpreting the smelting contract as permitting Hanna Nickel Smelting Company to treat the expenditures for additions, modifications, replacements or improvements to the facility as reimbursable costs of production, rather than as non-reimbursable capital expenditures.

2. The district court erred in holding in the alternative that the Government is estopped to assert approximately $320,000 of its claim because its employees failed to object during the performance of the contract to the disputed accounting practices employed by Hanna Nickel Smelting Company.

3. The district court erred in failing to hold The Hanna Mining Company liable in full on its admitted guarantee of proper performance of the contract by its wholly owned subsidiary, Hanna Nickel Smelting Company.

SUMMARY OF ARGUMENT

I

A. The contract in dispute was, in large measure, a cost-reimbursement type contract, providing for the purchase of nickel by the Government at a price adequate to reimburse Hanna Nickel Smelting Company its cost of producing the metal, and providing a device for awarding the contractor a profit. There is, however, one essential feature that distinguishes this contract from the ordinary cost-reimbursement contract; that is the provision for Hanna to design, build, and equip the smelting facility and to make such replacements and improvements in it as were necessary, with up to $22,875,000

of the Government's money. In order to assure that the investment of public funds in the facility would be limited to that ceiling, and that the contractor would not pass on to the United States as reimbursable costs of production the cost of items which were capital in nature, the contract established its own cost accounting system. Under that system, Hanna was required to capitalize expenditures (a) "to test the process," (b) "to construct, equip, design and rebuild" the smelting facility, (c) "for such replacements or improvements" of the smelter which the parties agreed to be necessary or advisable, and (d) for such other items "which, in accordance with generally accepted accounting practice, are capitalized" (Article VI). Moreover, such capital expenditures could be made by Hanna from public funds only if the Government agreed that they should be made. Ibid. And, under that system, costs of production for which reimbursement would be made were defined as the costs and expenses of the contractor except those expenditures made for capital purposes.

It is the Government's position that each of the 216 expenditures in dispute in this litigation was improperly treated by Hanna as a reimbursable cost of production. For each expenditure was for an addition, modification, replacement, or improvement to the smelting facility which, under the contract cost accounting system, should have been treated as a capital expenditure subject to the Government's veto and to the overall contract ceiling on capital investment. The district court rejected this reading of the contract, concluding that the

contract's terms were "ambiguous", and, therefore, that external accounting standards -- and not the contract cost accounting system -- must be referred to in determining the proper accounting treatment for expenditures under the contract. The court then concluded that the parties intended to be applicable peculiar accounting practices used by some firms in the smelting industry -- for example, the practice of treating only the original investment in the smelting facility as a capital expenditure, and treating all subsequent expenditures for replacements and improvements to the facility as costs of production unless they materially increase the capabilities or value of the plant considered as a whole.

The standards adopted by the court below are wholly incompatible with the contract as it was written by the parties. The mere fact that the smelting contract is lengthy and its provisions complex was no reason for concluding that it was "ambiguous" and for ignoring its relevant terms. The result of reading the contract as requiring the application of smelting industry accounting practices is that whole sections of the contract are left entirely without meaning while others are emasculated. Thus, while the contractual language clearly calls for the capitalization of expenditures for "replacements" modifications, additions and "improvements", under the district court's holding, replacements and modifications may <u>never</u> be capitalized, while additions and improvements are rarely capitalized. As a result, Hanna has been permitted to charge to the Government, as ordinary expenses of production the cost

of huge pieces of equipment purchased for large sums of money and having useful lives of many years. The further result is that Hanna has received these pieces of equipment free, and at the time of the trial was still using more than one-half of them for the profitable commercial production of nickel.

B. Because the provisions of the smelting contract resulted from negotiations and bargaining between the parties, and not merely because some Government procurement manual required their inclusion in the contract, there is considerable evidence documenting the intent of the parties when they entered into the contract as to expenditures that would be capitalized and those that would be expensed. These documents show that the interpretation accorded the contract by the district court is wholly inconsistent with the parties' intent in 1953 when they entered into the contract. Indeed, the evidence shows that during negotiations Hanna did not even go so far as to suggest that accounting practices in the smelting industry should be the standard. Hanna's suggestion was only that it should be permitted to treat as reimbursable costs of production those expenditures which would under generally accepted accounting practices -- i.e., practices accepted in industry in general and not merely in some segment of the smelting industry -- be treated as costs of production, and that it should be allowed to capitalize those expenditures which would be capitalized under generally accepted accounting practice. But even this language, making the test of generally accepted accounting practice applicable, was not incorporated in

those established by the contract's own cost accounting system (with one minor exception, as to which generally accepted accounting practice was specifically made applicable).

C. There is also uncontradicted evidence showing that the Government insisted upon and was expressly given the right to veto expenditures by Hanna for additions, replacements, and improvements it deemed unnecessary or unadvisable. Nevertheless, the district court interpreted the contract to deprive the United States of its veto by approving Hanna's unilateral determination to expend Government funds for the disputed expenditures. The additional result is that the effective ceiling the United States set on the capital investment it would make in the smelting facility has been increased by the district court decision by almost $1,400,000.

D. In addition to the contemporaneous evidence of contract intent and the plain language of the contract indicating that the disputed expenditures should have been capitalized, the record further shows that, during the eight years Hanna performed the contract it frequently interpreted the contract as requiring the capitalization of expenditures virtually identical to those in dispute here. This evidence plainly dispels any doubt that Hanna seriously believed during contract performance that the disputed practices were consistent with the contract terms.

II

We believe the evidence discussed in Point I conclusively shows the proper interpretation of the contract and the errors

in the district court's interpretation of it; this Court need read no further. However, in the event the Court should feel that the parties must, despite that evidence, have contemplated the application of some external standard -- and not solely the contract cost accounting system -- to guide the determination of whether expenditures for additions, modifications, replacements, and improvements should be capitalized, the external standard is that of generally accepted accounting practice, the only external accounting standard referred to in the contract, and not accounting practice peculiar to the smelting industry. And, the uncontradicted evidence establishes that generally accepted accounting practice achieves virtually the same results as the contract cost accounting system. For under that standard, the Government would be entitled to recover $1,618,545, which is only $23,430 less than it would recover if the contract cost accounting system were held applicable.

III

One error of the court below especially highlights its failure to give any weight to the uncontroverted evidence. Among the disputed items charged by Hanna to costs of production was the expenditure of almost $199,000 in connection with the purchase and installation of new dust collection equipment. The district court held that Hanna properly treated this entire amount as a reimbursable cost of production, on the ground it represented the cost of

removing old equipment. The court thus wholly ignored the stipulation, contained in the record, between Hanna and the United States that at least $114,000 of the disputed amount was spent in purchasing the new equipment. It followed from this stipulation that even under the interpretation of the contract adopted by the court below, the $114,000 should have been capitalized.

IV

Also plainly wrong is the "alternative ground" of decision below that the United States is "estopped by acquiescence" from complaining about the expensing of some $320,000 of disputed expenditures. Here, the Government's auditors were--at worst--guilty of neglect of duty or lack of diligence in failing to discover sooner that Hanna was employing improper practices (or, if they had actually discovered the practices, in failing to make them known to their superiors); their lack of diligence resulted in silence, which at most constituted an implied acquiescence in the practices, or laches. Utah Power & Light Co. v. United States, 243 U.S. 389. Laches is, however, a defense that is not available against the United States. Ibid.

But even if the Government's conduct could be construed as something more than an implied acquiescence, and even if the Government could be estopped because of the acts or

omissions of its field agents (compare FCIC v. Merrill, 332 U.S. 380), the elements of the defense of estoppel are lacking here. For there was no misrepresentation or concealment of material facts, nor an intent or expectation by the United States that Hanna would act on the Government's silence, nor evidence that any responsible Government official had actual knowledge of the facts of Hanna's practices. Moreover, Hanna did not change its position as a result of the Government's silence. In short, there was no basis for a holding of estoppel.

ARGUMENT

I

THE CONTRACT PROVIDED ITS OWN SYSTEM OF ACCOUNTING WHICH CALLED FOR THE CAPITALIZATION OF EXPENDITURES FOR ADDITIONS, MODIFICATIONS, REPLACEMENTS AND IMPROVEMENTS TO THE SMELTING FACILITY; THE DISTRICT COURT ERRED IN HOLDING THAT THE CONTRACT CALLED FOR THEIR CAPITALIZATION ONLY WHEN REQUIRED BY ACCOUNTING THEORIES OF THE SMELTING INDUSTRY.

A. The Language of the Contract Plainly Calls for the Capitalization of Expenditures for Additions, Modifications, Replacements, and Improvements to the Smelting Facility.

One needs little expertise either in the fields of law or accounting to recognize that if in a contract the parties agree to establish a particular system of accounting for expenditures under the contract, that system must be followed in order to fulfill the agreement. The accounting experts presented by both parties here agreed on this point (see Jul. Tr. 33,280). This is especially true, the Government's expert emphasized, where the contract involved is a cost reimbursement type contract (Jul. Tr. 30-31); for in such a case, improper allocation of the contractor's costs to the particular contract will result in the Government paying a greater price for the work than it bargained for. 29/ It is the Government's position in this litigation

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29/ The Government's expert, Dr. Howard W. Wright, was only recently quoted by the Court of Claims on this point in Lockheed Aircraft Corp. v. United States, ____ F. 2d ____ (Ct. Cl. No. 143-64, decided April 14, 1967) and United States Steel Corp. v. [continued]

that the smelting contract established its own accounting system, under which expenditures for additions, modification, replacements and improvements to the smelting facility should be capitalized, and not treated as costs of production. The district court rejected this argument, concluding that the contract languag was ambiguous and, therefore, that external accounting principles and practices must be referred to in determining the proper accounting treatment of the disputed expenditures. Then, going one step further, the court concluded that, although not referred to in the contract, the parties intended to apply external practices common only to the smelting industry -- mainly a practice, peculiar to the smelting industry, of capitalizing expenditures for replacements or improvements of capital equipment only if they materially increase the capabilities or value of the plant considered as a whole.

We show first below that, contrary to the district court's conclusion, the contract is not "ambiguous". To be sure, the contract is a complex document because many of the provisions are interrelated, spelling out the dual roles played by the United

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29/ [continued] United States, 367 F. 2d 399, 409. In the Lockheed case, the court stated (Slip op., p. 9, n. 5):

> [O]ne must be cautious in using "generally accepted accounting principles" as an aid in determining the allocability of costs to government contracts. Such principles have been developed for asset valuation and income measurement, and "are not cost accounting principles" as such, although "cost accounting concepts * * * [may] evolve out of" them. Wright, Accounting for Defense Contracts 29 (1962). See Wright, The Theory of Cost Principles, 18 Fed. B.J. 165, 169 (1958).

States (banker-purchaser of nickel) and Hanna Smelting (borrower-seller of nickel). However, a careful reading of the relevant provisions makes clear the accounting system the parties contemplated on January 16, 1953, when they entered into the smelting contract. And under that system, all the disputed expenditures -- which were made for replacements, improvements, additions, and modifications to the smelting facility -- should have been capitalized. We then show that the trial court's contrary reading of the contract is plainly incompatible with the terms of the contract.

1. The Accounting System Established by the Contract.

Article IV of the contract defines and describes the smelting facility that Hanna Smelting was to erect with money advanced by the United States; in pertinent part it provides (Pl. Exh. 2, p. 2):

> With advances made by the Government as provided in Article VI, the Contractor will construct and equip (including any necessary redesigning, rebuilding and repair) as promptly as possible a facility for the conversion of ore from the Mine into saleable ferro-nickel. * * * [T]he facility shall consist of one electric refining furnace, two electric slag melting furnace, a slag-disposal site and equipment, a stockpile site and stockpiling equipment, a sewage-disposal plant, railroad spurs, housing for personnel, preliminary construction and foundations for two additional electric melting furnaces and facilities as may be required after Period 1, and all equipment and facilities agreed to by the Government as necessary for such conversion of ore from the Mine into saleable ferro-nickel. * * * The facility, as it exists from time to time as contemplated by this article or as it may be substituted for from time to time with the approval of the Government, is hereinafter called "the Facility".

The plain meaning of this provision is that, with advances furnished by the United States in accordance with Article VI, Hanna Smelting agreed to "construct and equip" a smelting facility "including any necessary redesigning, rebuilding and repair" of the facility. Because the parties did not know exactly the equipment that would be needed when they entered into the contract (see pp. 66-67, infra) they agreed that the facility would consist of the few described items of equipment and, additionally, "all equipment and facilities agreed to by the Government as necessary for such conversion of ore." This plant -- "as it exists from time to time as contemplated by this Article or as it may be substituted from time to time with the approval of the Government" -- is to be called "the Facility" throughout the remaining provisions of the contract.

Article VI of the contract stated the conditions on which "capital" and "working capital" advances would be made. With respect to capital advances, amended paragraph 1 of the article (supra, pp.6-7) provided:

> Upon the Contractor's written request, the Government will make advances (hereinafter called "Capital Advances") of the entire amount up to a total of $22,875,000 (including the amount to be reimbursed to the Contractor under Article II) required
>
> (a) to test the process as provided in Article II, including the cost of mining and of shipping to France the quantity of ore from the Mine required for such tests on behalf of the Contractor,
>
> (b) to construct, equip, design and rebuild the Facility contemplated by Article

IV (including all costs and expenses incurred during or in respect of any periods of time within Period 1 that production of saleable ferro-nickel has ceased by reason of constructing, equipping, designing, rebuilding or repairing the furnaces or related equipment),

(c) for such replacements or improvements of the Facility which are agreed by the Contractor and the Government to be necessary or advisable during the period of this Contract, and

(d) for such other necessary and so agreed upon expenditures which, in accordance with generally accepted accounting practice, are capitalized. 30/

As for working capital advances, paragraph 2 of Article VI, provided (supra, p. 7):

> Upon the Contractor's written request from time to time * * * the Government will advance to the Contractor sums (hereinafter called "Working Capital Advances") representing its reasonable minimum working capital requirements so long as the sum of such request plus Working Capital Advances then outstanding does not exceed $3,750,000. * * * Working Capital Advances may be requested and used by the Contractor to pay any costs and expenses hereunder of the Contractor, including costs arising from the payment of tax liability or other source, not covered by Capital Advances and which are in excess of funds then available from the sale hereunder of ferro-nickel at the prices herein set forth [emphasis added].

Article VI also emphasized that capital advances and working capital advances were each to have their own, distinct purpose and were not to be intermingled by further providing (Pl. Exh. 1, p. 5):

30/ In the contract, clauses (a) through (d) are not tabulated; however, for ease in understanding, we have set them out above in separate paragraphs.

> 3. Capital Advances and Working Capital Advances shall be kept in separate accounts at a bank or banks approved by the Government; [and] shall not be commingled with each other or with other funds; * * * .

The language of Articles IV and VI makes clear that the provisions must be read together. For example, Article IV expressly states that Hanna Smelting should construct and equip the facility "with advances made by the Government as provided in Article VI." (Emphasis added). Similarly, clause (c) of paragraph 1, Article VI, states that capital advances would be made as required by Hanna "for such replacements or improvements of the Facility"; and "the Facility" had already been defined in Article IV of the contract as consisting of the specifically described equipment "and all equipment and facilities agreed to by the Government as necessary for such conversion of ore * * * ."

Reading the two articles together -- substituting the definition of "the Facility" in Article IV for the term "the Facility" in Article VI, paragraph 1, clauses (b) and (c) -- it becomes apparent that capital advances were to be made to Hanna Smelting:

> (b) to construct, equip, design and rebuild the specifically described equipment 31/ and all equipment and facilities agreed to by the Government as necessary for such conversion of ore, and
>
> (c) for such replacements or improvements of the specifically described equipment and all equipment and facilities agreed to by the Government as necessary for such conversion of ore, which are agreed by the Government to be necessary or advisable during the period of this Contract.

31/ We have used the term "the specifically described equipment" rather than itemize the particularly described items in Article IV

The parties thus agreed in clause (b) that capital advances would be made upon Hanna's written request to cover expenditures to construct, equip, design, or rebuild any of the specifically described equipment or any of the additional equipment and facilities agreed to by the Government to be necessary or advisable during the period of the contract. In clause (c) the parties agreed that capital advances would also be made at Hanna's written request to cover expenditures for a replacement or an improvement (which was agreed to by the Government as necessary or advisable during the period of the contract) of a specifically described item of equipment, or for additional equipment and facilities agreed to by the Government as necessary for the conversion of ore. Under the accounting system contemplated by the contract, an expenditure for the replacement of a component -- rather than the entire unit -- of a specifically described item of equipment (or of an item not specifically described but agreed to by the Government) would not be covered by capital advances because it would not be an expenditure for the replacement of a specifically described item of equipment (or for the replacement of an item not specifically described but nevertheless agreed to by the Government as necessary or advisable). On the other hand, if the replacement of a component of an item effected an improvement in the item, it would be covered by capital advances under clause (c) because it would then be an expenditure for improvement of an item of equipment as specifically described or of an item added with the Government's agreement. An example of an expenditure for a "replacement" which

would not be covered by capital advances would be the purchase of a new light bulb to replace a worn one in a lighting fixture in the plant. Since the new bulb merely replaced a component of an item -- the lighting fixture -- it would not be capitalized.

Working capital advances, on the other hand, were to be "used by the contractor to pay any costs and expenses hereunder of the Contractor * * * not covered by Capital Advances" (Article VI, paragraph 2, emphasis added). The plain significance of this provision is that if an expenditure came within the compass of the capital advance provision, it could not be paid for with working capital advances. For example, if Hanna Smelting wished to purchase a tractor for the facility, it would be entitled under clause (b), paragraph 1, Article VI, to purchase the tractor with capital advances -- provided the Government agreed the item of equipment was necessary for the conversion of ore and the capital advance ceiling had not been exceeded. Hanna could not under the contract avoid the need to obtain the Government's approval to the purchase of the tractor by using working capital advances because the expenditure would be "covered by Capital Advances"; therefore, it would not come within the purposes for which working capital advances could be used. Similarly, if Hanna properly followed the contract and purchased the tractor with capital advances, it could replace the tractor with a new one by using capital advances, provided the Government agreed the replacement was "necessary or advisable". Here again, it could not sidestep the requirement of obtaining governmental approval by purchasing the replacement tractor with working capital advances.

The discussion to this point related to the provisions dealing with the banker-borrower relationship. There was, in addition, the seller-purchaser relationship between the parties. As previously mentioned (see pp. 8-9 , supra), Hanna was to sell smelted nickel to the United States at a price designed to reimburse it for its "actual cost of production per pound of contained nickel" (Article VIII). 32/ "The Contractor's actual cost of production" was defined, as here relevant, as all "unrecovered costs and expenses hereunder of the Contractor * * * not covered by Capital Advances and which arise from operations * * * ." Thus, if an expenditure were "covered by Capital Advances" -- i.e., if the contract required capital advance rather than working capital advance treatment of the expenditure -- it could not be treated as part of Hanna's "actual cost of production" for which reimbursement by the United States would be made. In short, if an expenditure came within the capital advance language of the contract, it could not be covered with working capital advances and thereafter treated as a reimbursable actual cost of production.

All but one of the 216 items of disputed expenditures in this litigation, costing a total of $1,392,376.55, were covered

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32/ In accordance with the contract, Hanna Smelting would submit an invoice to the Government charging it for delivered metal at the agreed price per pound. Deducted from the invoice price was an amount known as the "amortization payment" -- an amount calculated to amortize over the first 95,000,000 pounds delivered the capital advances made by the United States during the contract term (see Article VIII, supra, p. 8).

by the language of the capital advance article.[33] As Plaintiff's Exhibit 90 demonstrates, these expenditures were all for additions, modifications, replacements, or improvements. Because of our understanding of the appellees' position in the court below to be that if the Government's interpretation of the contract (as outlined above) is correct, then the United States is entitled to recover all these disputed amounts, we will not pursue the matter further in this brief.[34] If the court adopts the interpretation we have suggested above, then the Government should be awarded the total amount of $1,392,377.00 plus interest (rather than only the $231,506 plus interest awarded by the court below to cover the six major and thirty-two minor disputed items held improperly charged to costs of production). In addition, the Government's recovery on reformation of the contract should be increased by $ 7,800 to reflect the taking out of costs of production

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33/ The one item not covered by the capital advance language is item 77, a bonus of $1,192.48 paid to a Bechtel Company superintendent. Hanna nevertheless improperly obtained reimbursement from the United States for this expenditure. The agreed description of this item in Pl. Exh. 82 indicates that there was "no contractual obligation to make this payment." If Hanna wished to reward a Bechtel employee for meritorious service it was, of course, free to do so. A contractor with the United States under a cost reimbursement contract may not, however, dispense gratuities and then pass their cost on to the public. Cf. Hotpoint, Inc. v. United States, 117 F. Supp. 572, 575-576 (Ct. Cl.) in which the court prohibited a cost-plus contractor from obtaining reimbursement from the Government for charitable contributions.

34/ In Defendant's Brief after Second Trial filed in the court below, appellees stated (at p. 6) that if "the Government's construction prevails it is quite clear that most if not all of the disputed items were in a sense literally additions or replacements or improvements."

during 1959 and 1960 of the various disputed expenditures erroneously charged to costs of production in those years.

2. The District Court's Reading of the Smelting Contract Is Wholly Incompatible with its Terms.

The district court rejected the interpretation of the contract we have suggested above, concluding that "the terms in Article VI, paragraph 1, are ambiguous, and that other provisions relied on by the Government do not resolve the ambiguity" (R. 383). The court then denied the major portion of the Government's claim on the basis of its conclusion that "the parties intended to apply accounting practices common to the smelting industry in determining whether the disputed items should be treated as costs of production" (R. 387). "Under these practices", the court state, "replacements or improvements, even if long-lived are expensed unless they materially increase the capabilities as value of the plant considered as a whole" (R. 386). Hanna's failure to capitalize another substantial group of expenditures, representing the cost of additions of long-lived pieces of equipment to the smelting facility and of modifications to then existing equipment, was also upheld on the ground that Hanna Smelting "reasonably and properly employed accounting practices which reflect the experimental nature of this smelter" (R. 387).[35/]

35/ Concerning this practice, Hanna's accounting witnesses had testified (R. 386):

> [W]hen an inadequate item is replaced or rebuilt in an experimental operation, the cost of modification, and in some cases the cost of new equipment, is [continued]

Hanna's treatment of another group of expenditures as costs of production was upheld by the court below under an accounting practice called the "receding face theory." 36/ While the district court did not specifically state that this theory was one of the "accounting practices common to the smelting industry" which it believed the parties intended, that obviously was the primary reason for the court's holding the theory applicable; for the district court pointed out that these expenditures "did not increase the capacity of the plant, but only enabled it to continue operations," just as the expenditures for replacements and improvements were held properly expensed because they did not "materially increase the capabilities or value of the plant considered as a whole" (R. 387, 386).

Application by the district court of "accounting principles peculiar to the smelting industry" (including the receding face

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35/ [continued]
properly expensed when the modification adds no "essential value" to the plant. In their opinion, the modifications expensed by the Company enabled the smelter to achieve its originally designed capacity and added no essential value to it.

36/ More specifically, the district court stated (R. 387):

> The Company's witnesses relied on this theory to justify expensing $91,873.96 spent primarily to extend slag disposal facilities. The receding face theory was developed in mine accounting; it permits expensing the costs of improvements needed to reach and work the receding face of a mine. In a smelting operation, slag and other waste are stored in piles, and it is necessary continually to extend the dumping facilities over the growing piles. The witnesses testified that the new facilities did not increase the capacity of the plant, but only enabled it to continue operations. [Emphasis added.]

theory) and "accounting practices which reflect the experimental nature of this smelter" to justify the expensing of otherwise capital expenditures is wholly incompatible with the contract written by the parties. The plain language indicates that the parties contemplated that expenditures for additions, replacements, improvements, and modifications would be capitalized -- i.e., covered by capital advances. While the contract terms are complex, they are not "ambiguous"; and, in concluding that the contract was ambiguous and that Hanna's treatment of the disputed expenditures was reasonable and proper, the district court simply ignored much of the language used by the parties. See United States v. Dwyer Lumber & Plywood Co., 353 F. 2d 351 (C.A. 9), in which this Court reversed this same district court for having committed similar errors. In addition, the result of the application of the principles and practices by the court below is that there are virtually no such expenditures that must be capitalized. This interpretation leaves significant clauses of the contract virtually without meaning.

a. Article VI, paragraph 1, clause (c) (supra, pp. 6-7), provided that capital advances would cover expenditures "for such replacements or improvements of the Facility which are agreed by the Contractor and the Government to be necessary or advisable during the period of this Contract." The parties thus plainly expected that there would be expenditures for "replacements or improvements" which would have to be capitalized. The court below concluded that the parties intended the question of whether to capitalize or expense expenditures for "replacements

or improvements" to be governed by smelting industry accounting practice (R. 387). But under this practice "replacements or improvements, even if long-lived, are not expensed unless they materially increase the capabilities or value of the plant considered as a whole" (R. 387).[37/] The difference between this practice and accounting practices in industry in general (let alone the practices contemplated by the contract) is great. For example, if a spinning machine in a clothing factory or a stamping maching in an automobile factory is replaced with a new machine -- whether of the same kind or of an improved kind -- the expenditure for the new item would be capitalized under generally accepted accounting principles and practices (and then depreciated over the useful life of the machine). Hanna's experts so recognized (Jul. Tr. 204, quoted infra, p. 81). Under the smelting industry theory, the entire smelter is treated as a "single capital unit"; the replacement of one long-lived piece of equipment with another is expensed, even though the new unit generates profits over many ensuing accounting periods; and the installation of improved equipment is almost always expensed because rarely will an improved piece of equipment materially increase the value or capabilities of the smelter as a whole.

Thus, under the court's conclusion that smelting industry practices were intended, an expenditure for a "replacement" would

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37/ Significantly, while appellees' witnesses testified that this practice is "generally accepted in the smelting industry" they did not testify that the practice is employed by all firms in the smelting industry or for that matter by even the greater proportion of the industry, and the district court did not so find.

never be capitalized, but would always be treated as a cost of production. For the replacement of a unit of equipment in the smelting facility with a new unit of the same kind (for example, the replacement of a worn ladle with a similar ladle) could not possibly, in the language of the district court, "materially increase the capabilities or value of the plant considered as a whole" (R. 386). Similarly, expenditures for "improvements" would almost never be capitalized, since few, if any, improvements (even those costing many thousands of dollars and having useful lives of 15 to 20 or more years) in and of themselves affect the capacity of the plant as a whole.

A striking example of the type of expenditures the court believed should be expensed and not capitalized is furnished by Hanna's purchase in 1957 of two dutch ovens (see pp. 15-16, supra) at a cost of almost $97,000. Taking words in their normal meaning, the ovens were clearly both "replacements" and "improvements". For they replaced earlier ovens, and had a heating capacity double those they replaced (Pl. Exh. 82). And they had a useful life of 20 years (Pl. Exh. 166). Yet under the district court's ruling they were not improvements or replacements which had to be capitalized.

By reading into the contract that the parties intended expenditures for replacements and improvements to the smelting facility to be capitalized only if those expenditures were required to be capitalized under accounting practice in the smelting industry, the district court has virtually read out of the

contract clause (c), paragraph 1 of Article VI -- that capital advances would cover expenditures for replacements and improvements. The additional result is that Hanna has received free of charge many pieces of equipment which it has continued to use since the termination of the smelting contract in the extremely profitable commercial production of nickel. Indeed, the uncontradicted evidence is that at the time this case was being litigated in the court below, Hanna was still using disputed items which had cost a total of $715,859 -- or considerably more than one-half of the total dollar value ($1,392,377) of the disputed items -- for the commercial production of nickel (see Pl. Exh. 72).[37a/]

b. The court's approval of Hanna's expensing (rather than capitalizing) expenditures for additions and modifications because of an accounting practice which permits such treatment in the case of an experimental venture is similarly incompatible with the contract terms. As previously mentioned (supra, p. 6), Article VI, paragraph 1, clause (b), provided that capital advances would be made "to construct, equip, design and rebuild the Facility contemplated by Article IV * * *," and Article IV provided in pertinent part, supra, pp. 5-6:

37a/ To further aid the Court's understanding of the nature of the disputed items, we will submit prior to oral argument three copies of a document containing the agreed descriptions of each of the items that was still in use by Hanna (adapted from Pl. Exhs. 82 and 72) together with photographs of each such item (adapted from Pl. Exh. 83).

> With advances made by the Government as provided in Article VI, the Contractor will construct and equip (including any necessary redesigning, rebuilding and repair) * * * a facility for the conversion of ore from the mine into saleable ferro-nickel. * * * [T]he facility shall consist of * * * [the specifically described items of equipment such as one electric refining furnace], and all equipment and facilities agreed to by the Government as necessary for such conversion of ore from the mine into saleable ferro-nickel. * * * The facility, as it exists from time to time as contemplated by this Article or as it may be substituted from time to time with the approval of the Government is hereinafter called "the Facility". [Emphasis added.]

Under these provisions, capital advances were available for all additional equipment and facilities agreed to by the Government, and "to * * * rebuild the Facility" (i.e., for modifications). Despite this language, the court concluded that the cost of additions and rebuilding is properly expensed when the expenditure adds no "essential value" to the plant (R. 386). It is obvious

that almost no addition or modification adds "essential value" to the plant -- not even those costing many thousands of dollars such as some of the expenditures in dispute here -- and therefore almost no such expenditures would ever be capitalized. That result is plainly contrary to the language of the contract.

B. The History of Contract Negotiations Show that the Parties Deliberately Decided that Expenditure Such as those in Dispute Should be Capitalized Without Reference to Accounting Practices in the Smelting Industry, and that the Government Would Have a Veto Over the Expenditure of Public Funds for Additions, Replacements and Improvements.

The smelting contract is not a standard-form Government contract containing the usual clauses insisted upon by the United States on a take-it-or-leave-it basis. Instead, this contract resulted from extensive negotiations and bargaining between representatives of the Hanna companies and the Defense Materials Procurement Agency; moreover, much of the contract language was proposed by Hanna. A number of exhibits in evidence document those negotiations. They show that the district court's reading of the contract is entirely inconsistent with the intent of the parties as documented by their negotiations and bargaining. The exhibits further show -- ironically -- that the court's interpretation is, however, consistent with the contract language originally proposed by Hanna and specifically excluded from the contract at the Government's insistence.

The Government's initial discussion drafts of the contract, dated October 13, 1952, made no mention of "generally accepted

accounting practice" or of "generally accepted accounting practice in the smelting industry" [38] (see Pl. Exhs. 176, 177). [39] The draft provided for advances of up to $20 million for "the design, acquisition, installation and necessary rebuilding or modification of the facilities constructed under Article I * * * " (Pl. Exh. 177, p. 11). And the suggested definition of the smelting facility required Hanna to provide specifically enumerated items of equipment "together with all related equipment and facilities required to satisfy its obligations hereunder" (id. p. 2) -- again, no mention of generally accepted accounting practice.

Hanna's initial draft of the smelting contract (Pl. Exh. 138), dated November 24, 1952, contains the first mention of the term "generally accepted accounting practice." Significantly, not even that draft speaks in terms of "generally accepted accounting practice in the smelting industry." The "Capital Advances" article of Hanna's proposal provided for advances of up to a total of $20 million (Pl. Exh. 138, p. 6):

> (a) to construct, equip, design, rebuild and repair the Facility contemplated by Article III, and (b) for such replacements, additions, or improvements of the Facility which are deemed necessary or advisable by the Contractor during the period of this Contract and which, in accordance with generally accepted accounting practice, are capitalized. [Emphasis added.]

38/ As mentioned above (see pp. 50-51, supra), there is a great difference between generally accepted accounting practice and generally accepted accouting practice in the smelting industry

39/ Both exhibits are dated October 13, 1952; Pl. Exh. 177 is merely a "revised draft" of Pl. Exh. 176.

The provision of Hanna's draft defining "the Facility" provided (Pl. Exh. 138, p. 3-4).

> With advances made by the Government as provided in Article V, the Contractor will construct and equip (including any necessary redesigning, rebuilding and repair) as promptly as possible a facility for the conversion of ore from the Mine into saleable ferro-nickel, which * * * shall consist of * * * [specifically described items of equipment, such as one electric refining furnace, one electric smelter furnace, etc.], all equipment and facilities deemed by the Contractor necessary or convenient for such conversion, and any necessary or convenient licenses, easements or other rights * * *. [Emphasis added.]

Hanna's draft of November 24, 1952, also contained a price structure similar to the one in the contract as executed. It provided that Hanna would be paid for nickel based on its "actual cost of production per pound of contained nickel" (Pl. Exh. 138, p. 9), and proposed the following definition of "cost of production" (Pl. Exh. 140, p. 2):

> "Cost of Production" shall mean all costs and expenditures incurred (other than items of Capital Cost) from the beginning of Period 1 for the production of ferro-nickel as herein contemplated which, in accordance with generally accepted accounting principles, are considered as production costs, including but without limitation thereto, royalties, management and consultant fees, salaries, wages and bonuses, state and local taxes, insurance, interest on working capital, advances and any carry-forward of net operating losses in excess of the ceiling prices fixed and adjusted as in this Contract provided. [Emphasis added.]

The Government's negotiators objected to these provisions. One of the Government's negotiators stated in a memorandum to

his superior (Deft. Exh. 118, pp. 1-2):

> The language used in this article allows the Contractor to construct or provide any facilities that he wishes. Obviously there must be some check on this by the Government. At the end of the third line on page 4 of the draft the addition of the words "and agreed to by the Government as" will satisfy to this requirement
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> * * * * *
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> It will obviously be necessary to eliminate the capitalization of repairs, although the capitalization of rebuilding is satisfactory, and further, replacements, etc. deemed necessary or advisable by the Contractor must be agreed to by the Government.

Similarly, the attorney for the Defense Materials Procurement Agency who reviewed Hanna's draft wrote in a memorandum to the General Counsel of the agency (Deft. Exh. 120, p. 1):

> In Article V, Advances, repairs should not be charged to advances (p. 6), and the Government should have power to approve "necessary or advisable" expenditures by Contractor.

The contract actually executed did not give Hanna Smelting the unfettered discretion it had sought to determine what additional equipment (that is, what equipment in addition to the items specifically mentioned in Article IV) would go into the facility at Government expense. The contract did not provide that capital advances would cover "such * * * additions * * * which are deemed necessary or advisable by the Contractor," as Hanna had proposed (Pl. Exh. 138, p. 6). Instead, the final contract provided for capital advances "to construct, equip, design and rebuild the facility contemplated by Article IV," and "the Facility" was to consist of specific equipment

"and all equipment and facilities agreed to by the Government as necessary for such conversion of ore" (Articles VI and IV). In short, to satisfy the United States' objections to Hanna's drafts, additional equipment was not to be acquired with public funds unless "agreed to by the Government as necessary." The contract did, however, adopt the wording proposed by Hanna Smelting that capital advances would be used for, among other things, "to * * * rebuild * * * the Facility."

On a similar note, the Government rejected the language suggested by Hanna that capital advances would be available "for such replacements, additions, or improvements of the Facility which are deemed necessary or advisable by the Contractor * * * and which, in accordance with generally accepted accounting practice, are capitalized" (Pl. Exh. 138, p. 6). In the contract as executed, the phrase "which, in accordance with generally accepted accounting practice, are capitalized" does not modify the clause dealing with replacements and improvements. And "replacements and improvements" may be made only if "agreed by the Contractor and the Government to be necessary or advisable." Thus, Article VI, paragraph 1, provides that Capital Advances cover expenditures (supra, pp. 6-7):

> (a) to test the process as provided in Article II, * * *, (b) to construct, equip, design and rebuild the Facility contemplated by Article IV * * *, (c) for such replacements or improvements of the Facility which are agreed by the Contractor and the Government to be necessary or advisable during the period of this Contract, and (d) for such other necessary and so agreed upon expenditures which, in accordance with generally accepted accounting practice, are capitalized.

Under plain rules of English grammar, the phrase "which, in accordance with generally accepted accounting practice, are capitalized" modifies only "for such other necessary and so agreed upon expenditures"; the phrase does not also modify clause (c), as appellees urged below and as the district court apparently believed.

Finally, Hanna's proposal (supra, p. 55) that cost of production "shall mean all costs and expenditures incurred * * * which, in accordance with generally accepted accounting principles, are considered as production costs * * * " (Pl. Exh. 140, p. 2) does not appear in the final contract. Instead, "cost of production" is defined as all "costs and expenses hereunder of the Contractor * * * not covered by Capital Advances and which arise from operations * * * " (supra, p. 8), with no mention being made of "generally accepted accounting practice."

The record does not affirmatively indicate why the definition in Hanna's drafts which would have provided capital advance treatment only for those "replacement[s], additions, or improvements * * * which, in accordance with generally accepted accounting practice, are capitalized" was rejected. Neither does the record indicate why cost of production was not defined, as Hanna had suggested, to mean "all costs and expenditures incurred * * * which, in accordance with generally accepted accounting principles, are considered as production costs." The

fact is, however, that the contract as entered into by the parties does not make "generally accepted accounting practice" the test of whether expenditures for "replacements or improvements" are to be capitalized. And it certainly did not make "generally accepted accounting practice in the smelting industry" the standard. Rather, it provided for a system of accounting calling for the capitalization of additions, modifications, replacements or improvements, a system close to but not identical with, generally accepted accounting practice. See infra, p. 77-81. Considering that even the provisions suggested by Hanna which would have made "generally accepted accounting practice" the standard are not contained in the contract, the court's conclusion that "generally accepted accounting practice in the smelting industry" was intended is plainly erroneous.

C. The District Court's Interpretation of the Contract Deprives the Government of its Right To Veto Capital Expenditures, and Permits Hanna Smelting To Avoid the Ceiling on Such Expenditures.

We have shown above that the district court's interpretation of the contract is contrary to the contract terms and the intent of the parties as evidenced by the history of contract negotiations. We now show that application of "accounting practices peculiar to the smelting industry" and accounting practices which the court held applicable because of the experimental nature of the smelter deprive the United States of its contract right to veto expenditures for additions, replacements, or improvements. The district court's interpretation of the contract also completely overrides the understanding of the parties that the Government would pay no more for capital items than the $22,300,000 of capital advances authorized and approved.

1. The contract as executed (Article VI, paragraph 1, clause (c)) provided capital advance coverage "for such replacements or improvements of the Facility which are agreed by the Contractor and the Government to be necessary or advisable." We have shown (pp. 56-58 , supra) that the parties agreed to confer this veto power over expenditures for "replacements and improvements" despite Hanna's initial proposals that would have allowed it unilaterally to determine whether expenditures for replacements or improvements should be made. The district court, by concluding that the parties intended expenditures for replacements or improvements to be capitalized only

if they would be capitalized under smelting industry accounting practice, has read the veto out of the contract. For, as previously discussed (see pp. 44-45 , supra), Hanna was permitted to incur at Government expense costs of production without the Government's approval, and, under the district court's interpretation, the disputed expenditures for all replacements and virtually all improvements were properly treated as costs of production. In this manner, the court below approved Hanna's having deprived the United States of its veto over such expenditures.

Similarly, the court's conclusion that expenditures for additional equipment for the smelting facility were properly expensed (and not capitalized) because of the experimental nature of the smelter deprives the Government of its contract right to veto such expenditures. It should be recalled (see p 5, supra) that under Article IV Hanna was to equip the Facility with the specifically described items of equipment and all additional "equipment and facilities agreed to by the Government as necessary for such conversion of ore." This veto over expenditures for additions, the evidence of contract negotiations demonstrates (see pp. 57-58 , supra), was also inserted in the contract over Hanna's initial objections. Here again, the court below read the veto out of the contract by concluding that, because the smelter was experimental, additions could be expensed -- and the need for obtaining Government

approval avoided -- if they did not add "essential value" to the smelter. Of course, the court found no addition as meeting that test of adding "essential value" despite the fact that many of them cost thousands of dollars and were expected to, and did, benefit many years of Hanna's commercial operations of the smelter. See Pl. Exh. 72 and pp. 52-53, supra.

2. Apart from depriving the United States of its express contract right to veto expenditures for additions, replacements, and improvements, the district court's interpretation of the contract nullifies the understanding of the parties when they entered into the contract that the United States would not pay for capital expenditures beyond the amount of capital advances requested and authorized. As we have noted (supra, p. 6), the contract set a fixed ceiling on the capital investment the Government would make in the smelting facility. That ceiling, originally set at $22 million, was increased at Hanna's request to $22,875,000. The contract did not, however, set a fixed ceiling on costs of production that would be borne by the public Treasury.[40/] By not requesting and using capital advances for the $1.4 million in dispute here, Hanna not only deprived the Government of its veto over such expenditures but also caused the Government to pay for capital expenditures beyond its commitment to the extent of those expenditures. For the

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40/ The contract, however, did set a ceiling price per pound on costs of production. That price per pound was changed from time to time; and, with a minor exception, Hanna was able to stay within that limit during the term of the contract; moreover, Hanna recouped costs above the ceiling when it subsequently produced nickel under the ceiling price. Thus Hanna was reimbursed in full for all its costs of production.

contract provided that "upon the Contractor's written request, the Government will make" capital advances "up to a total of $22,875,000" (supra, p. 6); however, capital advances of slightly less than that amount, totalling $22,300,000, were requested, approved, and advanced (R. 298). Accordingly, although the Government thus committed itself to a capital investment of no more than $22,300,000, Hanna caused the Government to make an additional capital investment of almost $1.4 million by charging capital expenditures to costs of production. The result is that public funds were used to purchase equipment which Hanna never paid for,[41] but which Hanna obtained free and used in the commercial production of nickel. This result reached by the court below is plainly incompatible with the contract.

D. During the Eight Years it Performed the Contract, Hanna Smelting Interpreted it as Requiring the Capitalization of Numerous Expenditures for Additions, Modifications, Replacements, and Improvements Which Are Virtually Identical to the Expenditures it Now Claims Should Not Be Capitalized.

In addition to the contractual language and the history of the negotiations, which we have considered to this point, during contract performance Hanna Smelting sought to capitalize numerous expenditures for additions, modifications, replacements, and

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41/ The contract gave Hanna the right to purchase the whole smelting facility at 7 1/2% of the capital expenditures. Hanna of course exercised that right (see supra, p. 9). But since the disputed items were not included in the capital expenditures, it received them free.

improvements which would not be capitalized under the theories advanced by Hanna in this litigation and held applicable by the district court. Surely, had it been Hanna's original interpretation of the contract that the "single capital unit", the "receding face" and the "experimental nature of the smelter" theories applied, it would also have attempted to treat those expenditures as costs of production (and thereby avoid the Government's veto and the ceiling on capital expenditures).

1. The record shows in this connection that on April 7, 1953, less than three months after the smelting contract was executed, L. W. Spang, -- who is an attorney, and was the Secretary of Hanna Nickel Smelting Company, and was one of its primary contract negotiators [42] -- wrote Messrs. Humphrey and Pierce of Hanna's Cleveland office [43] as follows (Pl. Exh. 42, p. 2):

> I am clearly of the opinion that under those provisions [Articles IV and VI, paragraph 1] the Government is firmly committed up to $20,000,000, subject only to its right to agree with us what facilities are required, in addition to those specified in the Contract, to produce the quantity of ferronickel called for. * * * [Emphasis added.]

Thus, in the early days of contractual performance, a high official -- one who had a great deal to do with drafting the

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42/ See R. 212 and Oct. Tr. 25.

43/ While that letter does not state the titles of Messrs. Humphrey and Pierce, the stipulated facts indicate that both gentlemen at various times were president of Hanna companies in Cleveland (R. 212).

contract -- recognized that the contract required Hanna to obtain the approval of the United States to expenditures for additional equipment or facilities. This is the very interpretation the district court rejected!

Subsequently, on February 28, 1955, after the contract had been in existence for more than two years, Spang wrote to the Company's General Manager in Oregon as follows (Pl. Exh. 44):

> [W]e should make a report to the Government showing the respects in which the plant, as constructed and equipped for the present operating period, varies from the Contract provision, and request the Government's approval of any such variations. * * * In connection with any items abandoned and any additional items installed, we should point out the necessity for them and also the approximate costs.

In response to Spang's request that he send the necessary information and Spang would "put together a report to the Government and request its approval to any changes, so that we are completely covered as to the facilities constructed and installed" (Pl. Exh. 44), the General Manager on March 8, 1955, sent Spang "a list of the major items" of "constructed and installed facilities not included in the language of Article IV" which totalled almost $2 million (Pl. Exh. 45). The letter pointed out that some of the expenditures listed "included changes, additions or alterations * * *" (ibid.). Thereafter on January 4, 1956, Spang wrote to the General Services Administration as follows (Pl. Exh. 47, p. 1):

> At the time the above Contract was entered into, detailed specifications for the plant had not been completed, and therefore it was necessary to describe the facilities in the Contract in very general terms and as such facilities then were contemplated.

After quoting the description of the Facility in Article IV, Spang's letter to GSA pointed out that "provision was made also for such other equipment and facilities agreed to by the Government as necessary," and that "[f]inal plans and specifications for the plant include some changes in and additions to the facilities as described in the Contract and subsequent operating experience has suggested others" (ibid.). The letter then stated (id., p. 2):

> [B]ecause of the provision quoted above from the contract [Article IV], we believe it would be in our mutual interest for the record to show that the equipment and facilities reflected in the summaries and against which funds have been advanced are agreed to by the Government as necessary for the conversion of ore from the mine into ferronickel. * * *. Accordingly, we request for the record your concurrence in the construction and installation of such equipment and facilities.

On May 14, 1956, GSA replied to Spang that, on the basis of an inspection of the facilities by a GSA engineer and Hanna's "representations," "the additional facilities installed at the time of this inspection are agreed to by the Government as necessary for the conversion of ore from the mine into saleable ferro-nickel" (Pl. Exh. 48).

The record also indicates that in the meanwhile, when $21,079,709 of the then authorized $22 million of capital

advances had been expended, Hanna stated to the Government that an additional estimated minimum of $1,080,000 of capital costs were contemplated (Deft. Exh. 105, p. 2).[44/] At that time, in order to cover those costs and not exceed the $22 million ceiling, Hanna suggested the following amendment to the contract: "That up to $1,500,000 of the presently authorized $2,800,000 of working capital be permitted to be expended for capitalizable expenditures if and when required in our judgment" (id. at attachment p. 2). At a meeting between Hanna Government officials, this proposal was discussed and Hanna was informed that the Government would not permit a transfer from working capital advances to capital advances (Deft. Exh. 105, p. 2). If the district court decision stands, Hanna nevertheless accomplished the very thing to which the Government refused then to give its consent -- it subsequently used working capital advances to add equipment to the plant.

The record further shows that thereafter -- and even while Hanna was developing its practice of charging expenditure for modification and additions to costs of production -- it still capitalized some such expenditures (which obviously, because of the small amounts involved, could not have added "essential value" to the plant). For example, in January 1957 $3,283.54, and in February 1967 $4,569.33, paid to the Bechtel

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44/ The attachment is the draft of a proposed letter given to the Government's negotiators (Deft. Exh. 105, p. 2).

Corp. by Hanna for "design changes in building and facilities" were capitalized (Pl. Exh. 100, p. 15).

This series of communications and other evidence establishes that, during the early years of contractual performance, Hanna Smelting recognized that the contract did not give it the unilateral right to purchase additional equipment for the smelter with public funds. Instead, its conduct indicates it understood the contract required it to obtain the approval of the Government to the additional equipment installed in the smelter, and that expenditures for such additional equipment and for rebuilding or modifications had to be made with capital advances. Among the disputed items in this litigation are hundreds of thousands of dollars of expenditures for additions to the smelting facility as to which Government approval was never sought and numerous expenditures for modifications, all of which were expensed (see Pl. Exh. 90). The district court's conclusion that the Government must nevertheless pay for these expenditures is plainly wrong.

2. The district court upheld Hanna's expensing of $91,873.96, spent primarily to extend slag disposal facilities, under the "receding face theory" because "the new facilities did not increase the capabilities of the plant, but only enabled it to continue operations" (R. 387). It should be recalled that Article IV of the contract required Hanna Smelting to construct, with advances made by the Government, a facility

consisting of specifically enumerated items of equipment and all additional "equipment and facilities agreed to by the Government as necessary for such conversion of ore from the mine." One of the specifically described items of equipment required was "a slag-disposal site and equipment" (Pl. Exh. 1, p. 3). It is undisputed that Hanna Smelting capitalized -- i.e., used capital advances to construct -- the other specifically described equipment. There is no basis for permitting a different treatment of the cost of the "slag-disposal site and equipment" because of the "receding face theory [which] was developed in mining accounting."

Furthermore, Hanna's present position that expenditures related to the slag disposal site should not be capitalized is contrary to Hanna's belief, documented in the record, before the disputed expenditures were made. In 1957 Hanna Smelting had asked GSA to increase the ceiling on capital advances by $875,000 (see p. 71, infra, and R. 219). Hanna's General Manager in Oregon, on June 21, 1957, sent the Company's Secretary in Cleveland a list to support Hanna's request for $875,000 "of additional capital requirements" (Pl. Exh. 52, p. 1). One of the major groups of items in the list was the following (id. at p. 2):

ITEM 05 - SLAG DISPOSAL FACILITIES:

a.	Change No. 16 and No. 17 belts from 18" to 24"		1958	45,000
b.	Extensions to slag conveyor belts 2000' at $50 per foot	$20,000	1957	
		40,000	1958	
		40,000	1959	100,000
c.	Improvements in granulating layout		1958	50,000
	Total			$195,000

Hanna's General Manager further described the capital needs with respect to "slag disposal facilities" as follows (id. at p. 4):

> Under Item 05, Slag Disposal Facilities, item "a" covers the enlarging of the first two slag conveyor belts. We have found that because of the tendency of granulated slag to stick to the belts, the present 18" belts are inadequate, causing premature belt failures. Item "b" covers additional belt to stack slag. Our slag dump is about 200' high and the extensions mentioned will take us to the limit of our slag stacking area; thereafter, they will be fanned around to completely fill the area. Item "c" covers certain improvements to be made in the general slag granulating area. * * * [Emphasis added.]

Hanna Smelting's request that the ceiling on capital advances be increased by $875,000 was granted on November 8, 1957 (R. 206). As shown above, one of the bases for Hanna's request for additional capital advances to be authorized was its belief that it needed additional capital advances for the slag disposal site. And, the evidence further shows, all of that capital advance money was to be spent to improve and extend the already existing facilities -- for example, $100,000 was to be used to extend the slag conveyor belts (the very items which comprise the bulk of the disputed $91,873.96). Despite these facts, Hanna Smelting subsequently treated the money spent to extend the slag disposal facilities as costs of production. The district court's conclusion that this treatment was proper because the receding face theory is applicable is contrary not only to the language and history of

the contract, but also to Hanna's interpretation of the contrac prior to this litigation.

3. Equally strong evidence reflects on Hanna's treatment during contract performance of expenditures for replacements and improvements. For example, the record shows that on February 21, 1957, the General Manager of Hanna Smelting's operations in Oregon wrote to R. C. Fish in Cleveland (who apparently was the Company's president at that time, see R. 212) a detailed letter which began with the sentence: "The last time you were here we discussed the possibility of additional capital money being required to complete or make required additions to the present plant and make such changes as appeared necessary or feasible to promote good operation" (Pl. Exh. 51, p. 1). The letter included "a complete list" of such items estimated as costing a total of $1,021,200. On the list were amounts for "enlarged and improved dutch ovens"[45/] and numerous other items that were preceded by the word "improved," "better," "larger," or "replace" (id. at pp. 1-2). The brief descriptions of the items in that letter indicate that they were of substantially the same kind as the items in dispute here, and that few if any of them were capitalizable under smelting industry accounting since, in the

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45/ As mentioned previously, the dutch ovens were in fact subsequently replaced by Hanna Smelting with new ones (see p. 15 , supra). The more than $97,000 spent for those new ovens was, however, treated as a cost of production.

words of the court below, they would not in and of themselves "materially increase the capabilities or value of the plant considered as a whole" (R. 386).

Thus, Hanna Smelting at the time that letter was written believed (contrary to its current position) that capital advances had to be used for replacements or improvements to the smelting facility. Hanna's recognition of this is underscored by the statement in the letter that "some of the minor shop tools could and probably should be charged to Cost" (Pl. Exh. 51, p. 2). The statement indicates that Hanna's General Manager considered, and rejected, the thought that all of the items listed in his letter, and not merely the expenditures for shop tools, similarly "could and probably should be charged to Cost."

In the meanwhile, GSA's engineer had examined Hanna's Oregon facilities and had recommended that the capital advance ceiling of $22 million authorized be increased by $875,000 (Deft. Exh. 28, Report p. 4; Pl. Exh. 52, p. 1). Accordingly, Hanna's General Manager was requested to modify his previous estimates and show "in detail our request for $875,000 of additional capital requirements" (Pl. Exh. 52, p. 1). By letter of June 21, 1957, to Hanna's Secretary the General Manager forwarded a list of over 25 items estimated as costing a total of $875,000 of "additional capital requirements" (ibid.).

Included in this list were items such as the following (Pl. Exh. 52, pp. 1-2):

Replacement of present flat bed	4,000
Replacement of 1 dump truck	4,000
Replacement of cars (total)	8,500
Replacement of 2 small payloaders	30,000
Replacement of large payloader	15,000
Replacement of small tractor	15,000
Replacement of fork lifts	24,000
Improvement of iron shredding facilities	50,000
Change No. 16 and No. 17 belts from 18" to 24"	45,000

It should be recalled that the district court found that Hanna Smelting had properly expensed, rather than capitalized, the replacements and improvements involved in this litigation because, under the "single capital unit" theory of smelting accounting, "replacements or improvements, even if long-lived, are expensed unless they materially increase the capabilities or value of the plant considered as a whole" (R. 386). Almost all of the items listed in Hanna's letter were the kind of item in dispute here. That is, they were "replacements" and/or "improvements" in the ordinary sense of those words, but which should be capitalized under the "single capital unit" theory. For example, the replacement of "cars" with new "cars," a "dump truck" with a new "dump truck," "payloaders" with new "payloaders," simply would not affect the capacity of the plant as a whole. Nevertheless, in 1957, contrary to smelting accounting practice, Hanna Smelting believed that these numerous items of replacements, improvements, and modifications should

be capitalized -- i.e., acquired with capital advances -- and should not be acquired with working capital advances and then treated as costs of production.

It is especially significant that Hanna proposed to ask for additional capital advances to be authorized to cover "the enlarging of the first two slag conveyor belts" from 18 inch to 24 inch belts (Pl. Exh. 52, p. 2, Item 05(a), and p. 4). One of the disputed expenditures in this litigation (Item 222, Pl. Exh. 82) concerns $25,469.45 spent by Hanna in 1957 to convert a 24-inch conveyor belt system used in moving ore from the stockpile at the mine to the dryers to a 36-inch system. The total cost of the new system (which had a 15-year estimated useful life (see Pl. Exh. 166)) was treated as a cost of production (ibid.). The district court upheld this treatment, also on the theory that under smelting industry accounting practice this type of expenditure is properly expensed, even though the evidence, as summarized above, indicates that Hanna in 1957 proposed capital advance treatment for a virtually identical expenditure.

4. Other indications that Hanna Smelting recognized during contract performance that the parties intended the contract to be interpreted as the Government urges were found in Hanna's files during pre-trail proceedings and were introduced in evidence. For example, on August 8, 1956, when approximately 95 percent of total authorized capital advances had been drawn

by Hanna,[46] Spang drafted a proposed amendment that would have redefined "cost of production" to include capital expenditures (Pl. Exh. 145). The proposed amendment was not adopted. Under this proposal, cost of production was to be redefined as follows (id. at p. 1):

> Cost of production shall be the amount determined by the Contractor from time to time to be reasonably required to cover production costs, necessary capital expenditures not otherwise provided for, and working capital requirements.

Other documents found in Hanna's files demonstrate that even while Hanna Smelting was charging expenditures for replacements and improvements to costs of production, responsible officials of the Company -- ranging from the Secretary of the Company to the Company's accountant in Oregon -- were extremely concerned about the propriety of the practice under the contract. That evidence indicates that those officials believed that the expenditures were not properly costs of production and should have been capitalized. See Pl. Exhs. 163 and 164 (memoranda from the Company's Chief Clerk in Oregon), 49, and 65, pp. 48-50.[47]

46/ By July 1, 1956, one month prior to the date of the proposed language change, Hanna had drawn $20,870,000 of the then authorized total capital advances of $22 million (Pl. Exh. 7). By that time, too, Hanna had already charged a significant number of the disputed expenditures to cost of production (see Pl. Exh. 9).

47/ In attempting to meet the argument made in this section of our brief, appellees will undoubtedly stress that on various occasions Government officials expressed their views that generally accepted accounting principles and practices were to control Hanna's treatment of expenditures under the contract.

[continued]

EVEN UNDER GENERALLY ACCEPTED ACCOUNTING PRINCIPLES AND PRACTICES, 201 OF THE 216 DISPUTED EXPENDITURES SHOULD HAVE BEEN CAPITALIZED.

We have shown above that the contract itself sets the standards the parties intended to determine whether expenditures should have been charged to costs of production or capitalized. We have also demonstrated that the district court improperly read into the contract "accounting practice common to the smelting industry" and other accounting theories as the standard for determining whether expenditures should be capitalized. We now show that even should the Court feel that the contract is not sufficiently explicit in setting out the contract accounting system, and that the parties must have contemplated the application of an external standard in determining whether expenditures should be capitalized or expensed, the standard must be that of "generally accepted accounting

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47/ [continued] For example, the record indicates that on February 6, 1953, the Director of Financial Analysis for the Defense Materials Procurement Agency wrote Hanna stating in part: "In respect to the accounting methods which you will employ in connection with this contract, it is our policy to adhere to sound accounting practices and generally accepted accounting principles to the maximum extent possible" (Pl. Exh. 95, p. 2, emphasis added). This statement is by no means inconsistent with the Government's position in this litigation. As we shall demonstrate in Point II, infra, there is only a minute difference between the accounting system established by the contract and generally accepted accounting principles and practices. Accordingly, had Hanna complied with those principles "to the maximum extent possible" it would have been in substantial compliance with the contract. More significantly, however, this letter -- written within one month after the smelting contract was executed -- contains absolutely no reference to generally accepted accounting practice in the smelting industry, the standard Hanna (and the district court) believed applicable.

practice" the only external standard referred to in the contract The uncontradicted evidence, as we shall also point out, establishes that if generally accepted accounting practice is dispositive, then Hanna Smelting improperly expensed 201 of the 216 disputed expenditures costing a total of $1,372,845.57 (Pl. Exh. 172).

1. The capital advance provision does, of course, contain a reference to "generally accepted accounting practice." Clause (d), paragraph 1, of Article VI provides capital advance coverage "for such other necessary and so agreed upon expenditures which, in accordance with generally accepted accounting practice, are capitalized." Hanna argued in the court below that the phrase "which, in accordance with generally accepted accounting practice, are capitalized" must be read into clauses (b) and (c), so that only those expenditures for additions, modifications, replacements, or improvements which are capitalized under generally accepted accounting practice could not be treated as costs of production. And, it further urged, "in the smelting industry" must be tacked onto the phrase "generally accepted accounting practice" when reading the phrase into clauses (b) and (c). The absence of support for this contention and its incompatability with the rest of the contract has previously been shown; there is simply no evidence to indicate that the parties even thought "accounting practice in the smelting industry" the relevant standard when they entered into the contract (see pp. 54-60 , supra). We believe the contract

itself shows the accounting system intended by the parties to be applicable and that reference to generally accepted accounting practice should be unnecessary. However, should the Court be of the view that an external standard is necessary, the standard should be that of "generally accepted accounting practice" and not accounting practice peculiar to the smelting industry.

2. The various accounting experts presented by the parties testified as to the meaning of the term "generally accepted accounting practice." The Government's witness, Dr. Wright, testified that "generally accepted accounting practices are the mechanisms by which a particular company achieves the objectives of generally accepted accounting principles" (Jul. Tr. 78). And, Dr. Wright pointed out, generally accepted accounting principles are "a series of standards, a body of concepts"; they "represent the body of doctrine which provides the standards for measurement principally for the independent certified public accountant in forming an opinion with respect to the reliability of his client's financial statements" (Jul. Tr. 82, 78).

Hanna's experts were in substantial agreement with Dr. Wright. Richard Baker of Ernst & Ernst, for example, testified that generally accepted accounting principles "are the rules which have developed in order that proper financial information, proper financial statements, would prevail" (Jul. Tr. 158-159). A generally accepted accounting practice "is the application of these broad general concepts to a given situation" (Jul. Tr. 159). Bruce Smith of Price, Waterhouse &

Company testified for Hanna on this point as follows (Jul Tr. 212):

> The phrase, "generally accepted practice" goes back to the early 1930's, and so far as we have been able to find out, was first used in correspondence between the New York Stock Exchange and what we know today as the American Institute of Certified Public Accountants. It was then the American Institute of Accounting. They not only, so far as we can find out, used the phrase first at that time, but they did the same thing we are doing today. They used the term "generally accepted accounting principles" and "generally accepted accounting practices" interchangeably. [Emphasis added.]

The Government introduced evidence on its alternative position that, if generally accepted accounting practice were applicable, then 201 of the 216 disputed expenditures were improperly expensed and not capitalized. Plaintiff's Exhibit 172 contains a reclassification by Dr. Wright of items in three of the categories in Plaintiff's Exhibit 90 "to bring them into accord with generally accepted accounting practices." This uncontroverted exhibit establishes that if generally accepted accounting practices are applicable, then 15 of the 216 disputed items costing a total of $19,530.98 were properly expensed, and 201 items costing a total of $1,372,845.57 were improperly treated by Hanna as costs of production.

Hanna introduced no evidence to controvert this exhibit or Dr. Wright's testimony in this regard, adhering instead to its position that accounting practice peculiar to the smelting industry is applicable. Indeed, one of Hanna's accounting

witnesses, Bruce Smith, recognized that if generally accepted accounting practice and not practice in the smelting industry were applicable, Hanna could not prevail.[48] Accordingly, if the Court is of the view that generally accepted accounting practice is applicable, then the Government's recovery in the court below should be increased by $1,141,340 because of the improper expensing of capital items, and by $3,901 on the reformation point for items improperly expensed in 1959 and 1960.[49]

III

TREATMENT OF THE $114,234.82 SPENT FOR NEW DUST COLLECTION EQUIPMENT AS AN EXPENSE CANNOT STAND EVEN UNDER THE DISTRICT COURT'S INTERPRETATION OF THE CONTRACT.

The district court's conclusion that Hanna Smelting properly expensed disputed Item 49 (the sum of $198,746.62 expended for dust collection equipment) is deserving of special mention. For even if the Court were to reject the arguments previously advanced in this brief, and accepted the district court's interpretation of the contract, the Government would be entitled to recover $114,234 on the item.

48/ Smith testified as follows (Jul. Tr. 204):

> If we thought of the furnace in the same sense that we think of the cutting machine in the manufacturing operation, we would then have to say that when we replace that with a new one, we would be forced to capitalize it, but that is not the generally accepted accounting practice of the smelting industry.

49/ Under generally accepted accounting practice, the total recovery would amount to $1,372,846 for 201 disputed expenditures and $245,699 on reformation.

The original agreed description of this item in Plaintiff's Exhibit 82 may be summarized as follows: Among the equipment originally installed in the smelter were "cyclone type dust collectors in four areas of the plant. After operations began, Hanna Smelting determined that the problem of nickel dust escaping and poluting the atmosphere was considerably more acute than originally estimated. To rectify the situation, Hanna Smelting began "a progressive program of installing more efficient dust collecting equipment." At the four sites at which dust was produced, "bag-house type collection equipment" was installed. The equipment could not, however, be installed in the same location as the old equipment; additionally, the old duct work could not be connected to the new equipment and much of it was no longer usable because of deterioration. The entire work related to the new equipment was performed for Hanna by a subcontractor from March through December 1957 at a total cost of $893,364. Of this amount, $694,618 "were charged to a capital account." The remainder of $198,746.62, the agreed description continued, "represents expenditures for removing old collectors and removing and replacing the auxiliary duct work and was charged to cost of production during March to December 1957" (emphasis added).

At the trial before the district judge, Hanna's accounting experts testified that the company properly expensed the $198,746.62. Richard Baker of Ernst & Ernst testified that this

amount was properly expensed because it "represents the cost of taking out the old duct work which was worn out and wasn't working effectively, and certain amounts were [spent] in replacing the old one" (Jul. Tr. 182). On cross-examination, Baker was shown Plaintiff's Exhibit 89 -- a schedule indicating that a substantial portion of the $198,746.62 was actually spent not to remove the old equipment as Plaintiff's Exhibit 82 had indicated, but, instead, to fabricate, erect, and install the new equipment -- and asked how these expenditures in fact differed from the $694,618 that had been capitalized. Baker's response was: "I think that the large amount of these charges cover the putting in and actually replacing duct work that was already there, that was worn out and under any condition would have been necessary to replace" (Jul. Tr. 257).

On November 23, 1965, some four months after the trial before Judge Solomon, the parties entered into the following stipulation concerning the previously agreed description of item 49 and Plaintiff's Exhibit 89 (R. 336-337):

> With respect to Item 49 in plaintiff's Exhibit 82, the parties agreed that the disputed $198,747.62 represents "expenditures for removing old (dust) collectors and removing and replacing the auxiliary duct work." Plaintiff's Exhibit 89 states that, based on plaintiff's analysis of 20 of Hanna's purchase orders representing $162,168.65 of the disputed $198,747.62, the sum of $159,667.25 was expended for fabrication, equipment, erection and installation of new dust collection equipment and the sum of $2,501.40 was expended for modification, reworking and removal of old dust collection equipment. Plaintiff's Exhibit 89 was admitted in evidence provisionally and subject to defendants' objections of relevancy, materiality, correctness and veracity.

> Plaintiff and defendants agree that, because of the time and expense involved, full and complete verification of plaintiff's Exhibit 89 is not now practicable; the parties further agree that, of the total of $162,168.65, shown on plaintiff's Exhibit 89, (1) the sum of $114,234.82 was expended for fabrication, equipment, erection and installation of new dust collection equipment, and (2) based in part on Hanna's 20 purchase orders, but primarily on the estimate of the President of Medford Steel Company (which installed the dust collection equipment) contained in Medford's $76,440 contract bid to Hanna, that 43.2% of the subsequently executed $76,440 contract price was for removal of old duct work, stacks and multiclones of the old dust collection system, defendants do not agree that more than $114,234.82 represents expenditures for new dust collection equipment and contend that the sum of $47,933.83 of such $162,168.65 represents expenditures for removing old dust collection equipment.
>
> Except as qualified herein, defendants waive all objections of correctness and veracity to plaintiff's Exhibit 89; defendants continue to reserve objections of relevancy and materiality to plaintiff's Exhibit 89. [Emphasis added.]

This stipulation conclusively establishes that not less than $114,234.82 of Item 49 was spent not for removal of the old equipment and ducts but for "new dust collection equipment." Hanna's sole contention during the trial was that the entire amount of Item 49, $198,746.62, should be expensed because it was spent solely to remove the old equipment. It follows from the stipulation that "$114,234.82 was expended for fabrication, equipment, erection and installation of new dust collection equipment" (R. 337) and that the purpose of the expenditure was identical to the "expenditures totalling $694,618.00 which pertained to the new equipment, [which] were charged to a

capital account" (Pl. Exh. 82, Item 49). It equally follows that, at the very least, $114,234.82 should have been capitalized and not treated as a cost of production.[50/]

The district court's opinion indicates that it gave absolutely no consideration to the parties' stipulation. For the court described this disputed expenditure as follows (R. 381):

> In 1957, the Company installed a new dust collection system at a cost of $893,364. It capitalized $694,917.38 spent for new equipment, but expensed $198,746.62, the amount spent to remove and replace the original, inadequate equipment.

Contrary to the court's opinion, however, the stipulated fact, as we have shown, is that no more than $84,511.80 was spent "to remove and replace the original, inadequate equipment" and $114,234.82 was spent "for new equipment." Accordingly, even under the district court's interpretation of the contract (which we have shown is erroneous) Hanna Smelting was not entitled to treat the $114,234.82 as a cost of production and, therefore, was overpaid by that amount.

50/ Of course, should the Government prevail either on its main or alternative interpretations of the contract, the full amount of $198,746 spent for the dust collection equipment would be recoverable.

IV

THE DISTRICT COURT'S ALTERNATIVE HOLDING THAT THE GOVERNMENT "IS ESTOPPED BY ACQUIESCENCE" FROM COMPLAINING ABOUT MOST OF THE EXPENDITURES MADE AFTER 1957 IS ERRONEOUS.

As "an alternative ground of decision," the district court held "that, with two exceptions, the Government is estopped by acquiescence from asserting any claim for expenditures made after January 1, 1958" (R. 390). The "two exceptions" were Hanna's expenditures for six major items costing $215,110 which the court found were improperly expensed "solely to obtain reimbursement" and for the thirty-two items each costing under $1,000 which were expensed solely because they cost less than $1,000 (ibid). Estoppel was not applicable to the six items, the court found, because "the Government could not have anticipated the Company's use of this accounting method"; and the doctrine had no application to the thirty-two items, the court further found, because the practice of expensing items costing under $1,000 "was not consistently followed by the Company" (R. 390).

In its opinion, the court set out the factual basis for holding the Government estopped as follows: D.A.N. Pattarson, an employee of G.S.A. "now deceased", had audited Hanna's books on behalf of that agency (R. 392). The first audit was made during 1957 in Cleveland, and Pattarson had relied primarily on Ernst & Ernst's working papers (ibid.). "These working papers," the court found, "revealed the disputed expenditures and even contained memoranda on whether to expense or capitalize some of

the disputed items" (R. 392). In September and November 1958, a three-man team from the General Accounting office audited Hanna's books in Oregon (R. 393). Based on these facts the court found "there can be no doubt that Pattarson and the G.A.O. accounting team were charged with the duty of auditing the Company's accounting methods and that they knew or should have known of the practices in dispute." (R. 394) The court deemed it irrelevant "whether these accountants had authority to speak" for the Government, holding that they had "a duty to report the Company's practices to their superiors," and, therefore, the knowledge they had or should have had "must be imputed to their superiors" (R. 394).

Because the evidence on the point is conflicting, we do not challenge as "clearly erroneous" the district court's finding that Pattarson and the GAO accounting team "knew or should have known of the practices in dispute" from their audits. We strongly challenge, however, the conclusion that the United States is "estopped" because of the knowledge those auditors had or should have had from challenging Hanna's expensing of capital items costing $319,466.93 during the years 1958 through 1961.[51/] In the first place, the law is established that mere

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51/ As indicated in the court's opinion, disputed items costing a total of $550,972.93 were expensed from 1958 through 1961 (R. 392). Deducting from that amount the sum of $231,506.00, as to which the court held estoppel inapplicable, indicates that the court's estoppel holding, if affirmed, would bar the United States from recovering $319,466.93 of the disputed expenditures.

silence in the absence of an intent to deceive (undeniably the situation here) is at most an implied acquiescence and constitutes laches, not estoppel; it is similarly established that the Government is not precluded by the silence of its agents from asserting public rights. Moreover, equitable estoppel is in any event not applicable (even if it ever applied to the Government) because many of the essential elements of that defense are lacking.

A. At Most, the Government Was Guilty of Laches in Failing To Object Sooner About Hanna's Practices; Laches Is, However, Unavailable as a Defense Against the United States.

The doctrine of equitable estoppel is wholly inapplicable in the circumstances of this case. The undeniable fact is that the Government never made any misrepresentation, or indeed any representation at all. At worst, the Government's auditors were guilty solely of neglect of duty or lack of diligence in failing to discover sooner that Hanna was employing improper practices (or, if they actually had discovered the practices, in failing to make them known to their superiors); their lack of diligence resulted in silence, which at most constituted an "implied acquiescence" in Hanna's practices. But "implied acquiescence" is simply laches, and is not available as a defense against the United States. Utah Power & Light Co. v. United States, 243 U.S. 389, 403.

In Utah Power & Light, the Government sought to enjoin the continued occupancy without its permission of federal lands on

which the respondents, over a period in excess of twenty years, had constructed dams, reservoirs, buildings, and other improvements. In holding the grant of the injunction by the lower court proper, the Supreme Court held (id. at 409):

> As presenting another ground of estoppel it is said that the agents in the forestry service and other officers and employees of the Government, with knowledge of what the defendants were doing, not only did not object thereto but impliedly acquiesced therein until after the works were completed and put in operation. This ground also must fail. As a general rule laches or neglect of duty on the part of officers of the Government is no defense to a suit by it to enforce a public right or protect a public interest. United States v. Kirkpatrick, 9 Wheat. 720, 735; Steele v. United States, 113 U.S. 128, 134; United States v. Beebe, 127 U.S. 338, 344; United States v. Insley, 130 U.S. 263-265-266; United States v. Dalles Military Road Co., 140 U.S. 599, 632; United States v. Michigan, 190 U.S. 379, 405; State ex rel. Lott v. Brewer, 64 Alabama, 287, 298; State v. Brown, 67 Illinois, 435, 438; Den v. Lunsford, 20 N. Car. 407; Humphrey v. Queen, 2 Can. Exch. 386, 390 Queen v. Black, 6 Can. Exch. 236, 253.

Thus "implied acquiescence" may be a basis for the equitable defense of laches,[52/] but it provides no defense to a suit by the Government to enforce a public right.

It is, of course, firmly established that the Government is not precluded by the silence of its agents -- laches -- from asserting public rights. Utah Power & Light Co. v.

52/ As the Supreme Court noted in Southern Pacific Co. v. Bogert, 250 U.S. 483, 488, "[T]he essence of laches is not merely lapse of time. It is essential that there be also acquiescence in the alleged wrong * * *." More recently, in Costello v. United States, 365 U.S. 265, 282, the Court defined laches as "(1) lack of diligence by the party against whom the defense is asserted, and (2) prejudice to the party asserting the defense."

United States, supra, 243 U.S. at 403, 409; Costello v. United States, 365 U.S. 265, 281-282. In the Costello case, the Supreme Court stated the reason for the "principle that laches is not a defense against the sovereign" as follows (365 U.S. at 281):

> The reason underlying the principle, said Mr. Justice Story, is "to be found in the great public policy of preserving the public rights, revenues, and property from injury and loss, by the negligence of public officers." United States v. Hoar, 26 Fed. Cas. 329, 330 (No. 15,373). This Court has consistently adhered to this principle. See, for example, United States v. Kirkpatrick, 9 Wheat. 720, 735-737; United States v. Knight, 14 Pet. 301, 315; see also United States v. Summerlin, 310 U.S. 414, 416; Board of County Commissioners v. United States, 308 U.S. 343, 351; United States v. Thompson, 98 U.S. 486, 489.

In sum, therefore, even assuming that Government officials lulled Hanna into a sense of security by failing to object sooner to Hanna's erroneous accounting practices, because of "the great public policy of preserving the public rights, revenues, and property from injury and loss, by the negligence of public officers" (Costello v. United States, supra), their neglect does not preclude the Government from recovering over $319,000 of public funds to which it is (as we have shown) otherwise entitled.

B. In Any Event, the Doctrine of Estoppel Is Inapplicable Because Many of Its Essential Elements Are Lacking Here.

In one of the leading treatises on equitable remedies (the treatise relied on by the court below, see R. 390) the doctrine of equitable estoppel is defined as follows (3 Pomeroy, Equity Jurisprudence (5th ed.) 189):

> Equitable estoppel is the effect of the voluntary conduct of a party whereby he is absolutely precluded, both at law and in equity, from asserting rights which might perhaps have otherwise existed, either of property, of contract, or of remedy, as against another person, who has in good faith relied upon such conduct, and has been led thereby to change his position for the worse, and who on his part acquires some corresponding right, either of property, of contract, or of remedy.

The "essential elements which must enter into and form a part of an equitable estoppel" are more specifically stated by Pomeroy as follows (id. at pp. 191-192):

> 1. There must be conduct--acts, language or silence--amounting to a representation or a concealment of material facts. 2. These facts must be known to the party estopped at the time of his said conduct, or at least the circumstances must be such that knowledge of them is necessarily imputed to him. 3. The truth concerning these facts must be unknown to the other party claiming the benefit of the estoppel, at the time when such conduct was done, and at the time when it was acted upon by him. 4. The conduct must be done with the intention, or at least with the expectation, that it will be acted upon by other party, or under such circumstances that it is both natural and probable that it will be so acted upon. There are several familiar species in which it is simply impossible to ascribe any intention or even expectation to the party estopped that his conduct will be acted upon by the one who afterwards claims the benefit of the estoppel. 5. The conduct must be relied upon by the other party, and, thus relying, he must be led to act upon it. 6. He must in fact act upon it in such a manner as to change his position for the worse; in other words, he must so act that he would suffer a loss if he were compelled to surrender or forego or alter what he has done by reason of the first party being permitted to repudiate his conduct and to assert rights inconsistent with it. [Emphasis in original.]

This Court has adopted Pomeroy's criteria.[53/]

Even if the United States could ever be estopped because of the acts or omissions of its field agents (compare FCIC v. Merrill, 332 U.S. 380) the elements of estoppel are plainly lacking here. For example, there was no misrepresentation or concealment of material facts here (element 1); there was at worst a failure to assert the public rights of the Government earlier. Similarly, there was no evidence of any intent or expectation on the part of any Government official that Hanna would act upon its silence (element 4). Indeed, as we have noted above (supra, p.87), there was no evidence that any responsible Government official had any actual knowledge of the facts of Hanna's practices (element 2). Lastly, it is clear (and the district court recognized) that Hanna did not change its position as a result of the Government's conduct (element 6). On the contrary, Hanna had started its practice of expensing additions, modifications, replacements or improvements, rather than capitalizing them,

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53/ This Court has stated the "elements [which] must be present to establish the defense of estoppel" as follows:

> (1) The party to be estopped must know the facts; (2) he must intend that his conduct shall be acted on or must so act that the party asserting the estoppel has a right to believe it is so intended; (3) the latter must be ignorant of the true facts; and (4) he must rely on the former's conduct to his injury.

Hampton v. Paramount Pictures Corp., 279 F. 2d 100, 104 (C.A. 9, 1960). See also California State Board of Equalization v. Coast Radion Products, 228 F. 2d 520, 525 (C.A. 9, 1955). This statement and Pomeroy's are virtually identical, except that element (2) above combines Pomeroy's elements 1 and 4, and element (4) combines Pomeroy's elements (5) and (6).

long before the Government's silence became relevant. In short, it is clear that necessary elements of estoppel are lacking here, even if estoppel could run against the Government. As we have shown, the Government's inaction here constituted no more than laches, which cannot be asserted as a defense against the sovereign.

CONCLUSION

For the foregoing reasons, (1) to the extent the judgment of the district court denies the United States the relief sought, it should be reversed and the case remanded to the district court for the entry of an additional judgment against the appellees in the amount of $1,168,671 (or, if the Court adopts the Government's alternative position, in the amount of $ 1,145,241) together with interest at 6 percent per annum from the dates of the overpayments until the judgment is paid;[55] (2) to the extent the judgment of

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54/ The district court's reliance on Mahoning Investment Co. v. United States, 3 F. Supp. 622 (Ct. Cl. 1933), certiorari denied, 291 U.S. 675, for the proposition that a change in position is unnecessary where acquiescence is the basis for estoppel, is misplaced. The acquiescence relied on by the Court of Claims there was not mere silence as in the present case, but rather affirmative representations establishing that the taxpayer acquiesced in the Government's conduct.

55/ Prejudgment interest was not requested, and should not be awarded, on the portion of the judgment increasing the recovery under the 1964 termination agreement; that agreement contemplated an award without prejudgment interest in this litigation (see Pl. Exh. 3).

the district court awards the United States the relief sought, it should be affirmed and judgment entered in this Court, pursuant to Rule 24(1) of the Court's rules, for interest on the judgment below from April 27, 1966 (the date of entry of the judgment), until it is paid.[56/]

Respectfully submitted,

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May 1967

CERTIFICATE

I certify that, in connection with the preparation of this brief, I have examined Rules 18 and 19 of the United States Court of Appeals for the Ninth Circuit, and that, in my opinion, the foregoing brief is in full compliance with those rules.

ATTORNEY

56/ It is undisputed that the Hanna Mining Company "guaranteed the reimbursement" to the United States of any funds advanced to Hanna Smelting "which had been expended by Hanna in violation of the provisions of Contract DMP-50" (Agreed Facts, ¶ V, R. 299). The district court, apparently through oversight, neglected to enter judgment against The Hanna Mining Company on its guarantee of reimbursement for amounts found due on reformation. Accordingly the judgment to be entered by the district court against The Hanna Mining Company should be for the entire amount due from Hanna Smelting to the United States.

APPENDIX PURSUANT TO RULE 18(f) OF THE COURT'S RULES

Pursuant to Rule 18(f) of the Court's Rules, following is a table of page references to the record where the various exhibits were identified, offered, and received in evidence:

EXHIBIT	IDENTIFIED	OFFERED AND RECEIVED
Plaintiff's Exhibits:		
1 through 80	R. 246-249	Oct. Tr. 3-4
82 through 179	R. 315-318	Jul. Tr. 2
Defendants' Exhibits:		
1 through 110C	R. 241-245	Oct. Tr. 3
113 through 130	R. 324	Jul. Tr. 2